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Central Bank Background Papers on Monetary Policy Frameworks in the Arab Countries

AMF-BIS Third Working Party Meeting on Monetary Policy in the Arab Region

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Foreword

Papers collected in this volume were written for the Third Working Party on Monetary Policy in the Arab region organized jointly by the Arab Monetary Fund (AMF) and the Bank for International Settlements (BIS) in Abu Dhabi, the United Arab Emirates in November 2019. The meeting was attended by participants from 25 Central Banks and monetary authority agencies, of which ten Central Banks from outside the Arab region.

The meeting provided an opportunity to review and discuss many important issues related to monetary policies in Arab countries. Discussed topics covered recent economic and financial market developments and their implications for banks in the Arab Region. The meeting has also tackled some other technical issues related to monetary policy frameworks such as liquidity management amidst lower oil prices and rising public debt, the Islamic banks in hybrid banking systems, inflation targeting, and exchange rate regimes.

Papers included in this document shed light on the operational frameworks and implementation of monetary policy in **eleven Arab countries**. These papers were presented and discussed during the meeting.

On the experiences of Arab countries adopting fixed exchange rate regimes, the paper of **The Central Bank of Jordan (CBJ)** referred to the amendment of the law of the CBJ to include "financial stability" as a primary objective in addition to "monetary stability" as a response to the challenges posed by the Global Financial Crisis. The paper referred to some conventional and unconventional monetary policy interventions that have been adopted recently to ensure monetary and financial stability amid regional and domestic challenges.

The CBJ also succeeded in maintaining a sound and robust banking system, greatly capable of withstanding shocks. Thanks to the high level of capital adequacy, which is considered as one of the highest ratios in the region and the comfortable liquidity levels and banking profitability.

On the other hand, the CBJ has recently introduced many initiatives aiming at improving SME access to finance and encouraging banks to extend credit to the vital economic sectors, thereby improving job creation and economic activity. Furthermore, the CBJ has established a FinTech Regulatory Sandbox to support innovation and increase the effectiveness of financial services.

The paper of **The Central Bank of Bahrain (CBB)** sheds light on monetary policy management in the Kingdom, which has a leading position in the region as an open, free, transparent, and welcoming environment for investors. Bahrain, as a financial center in the region, has geared to promote the growth of the financial sector in numerous ways to cater for the increasing investor demand for Shari'ah compliant financial products and services.

The CBB is pioneer in introducing Shari'ah compliant liquidity management tools such as Islamic Sukuk Liquidity Instrument (ISLI) and Wakalah, to ensure a level playing field between Islamic and conventional banks and increase the efficiency of the monetary policy.

The paper of **The Saudi Arabian Monetary Authority (SAMA)** shows how the monetary policy responded to the international and domestic economic developments in 2018 and 2019. The Monetary Policy in Saudi Arabia is anchored by a fixed exchange rate to the USA Dollar. Because of SAMA's monetary policy framework and prudent macro-prudential policy, SAMA was able to weather various challenges over the past two years.

In line with SAMA's objective to maintain monetary stability based on current and evolving developments in the domestic economic and financial markets, SAMA has gradually raised the repo and reverse repo rate four times by 25 bps each in 2018. However, in 2019, SAMA has reduced the repo and reverse repo rates twice by 25 bps to reach 2.5 percent and 2 percent respectively against the backdrop of a slowing economy and in conformity with SAMA's objective of preserving monetary stability. In early 2018, the USD LIBOR curve had been increasing steadily in anticipation of the Fed's policy rate changes and market conditions, while SAIBOR (Saudi Arabian Interbank Offer Rate) remained stable, which resulted in a negative interest rate differential between the SAIBOR and LIBOR rates.

Consequently, SAMA took several measures to sustain monetary stability, including the suspension of the term repo facility and gearing its monetary policy operations toward reducing the liquidity levels. These measures led the SAIBOR to increase. Since LIBOR started to stabilize, the interest rate premium of SAIBOR was restored.

The paper of **The Central Bank of Iraq (CBI)** sheds light on efforts exerted to restore economic and financial stability. The Central Bank of Iraq Faced different economic and Political challenges, either on the local, regional, or global level. In addressing these challenges, monetary policy played a fundamental role in the Iraqi economy. These challenges enforced a huge burden and hard situations to be managed by the CBI. The monetary policy carried out by the CBI showed a very high degree of flexibility and capability to deal with these extraordinary events efficiently and successfully. Additional several updates of the monetary policy instruments, objectives, and switching toward non-traditional policy were adopted to achieves its objectives.

On the other hand, the paper of **The Central Bank of Oman (CBO)** confirmed the strong relationship between the monetary policy stance in Oman and the USA due to the fixed exchange rate policy adopted. The monetary conditions prevailing in the USA are automatically transmitted to the Omani economy due to its currency peg arrangement with the US dollar and open capital account. The empirical results of the Cointegration model presented in this paper also corroborate such transmission, as the US EFFR is found to be the driver of Oman overnight interbank rate.

Accordingly, the monetary policy normalization in the USA, pursued from December 2015 to December 2018, led to a tightening of monetary conditions in Oman as domestic interest rates increased considerably over the last three years. The tightening of monetary conditions, however, was not in accord with the business cycle in Oman and, in fact, affected consumption and investment, exacerbating economic uncertainty in the country.

On the other hand, as imported inflation is the primary driver of inflation in the Sultanate, global developments resulted in benign inflationary pressures during the last few years. Global developments, such as a subdued increase in non-fuel international commodity prices, appreciation in the US dollar, and transmission of the USA monetary conditions remained instrumental behind benign inflationary conditions in the Sultanate.

The paper of the **Palestine Monetary Authority (PMA)** sheds light on the unique challenges facing monetary policy management. PMA was established to serve a broad range of central banking functions as envisaged in Paris Protocol. However, the absence of the national currency prevents the formulation and implementation of a comprehensive monetary policy. Even though it does not conduct a comprehensive monetary policy in the customary sense, due to the absence of a national currency, PMA made relentless effort to enhance capabilities and put in place the requirements for formulating and conducting monetary policy in the future.

Within the frame of its plans, the PMA is considering the introduction of certificates of deposit (CDs) and manage government bonds and securities (once it introduced) to be initially marketed to banks operating in Palestine. These instruments would promote the stability of the financial system, help develop the local capital market, provide the necessary liquidity to the payments system on a day-to-day basis, and, when necessary, serve as a form of collateral that banks offer to the PMA against loans. Also, this will help to develop the interbank market by enabling banks to extend loans to one another against such CDs as collateral.

Also, by introducing such instruments, the PMA establishes the use of a vital monetary policy instrument. Therefore, it can create a yield curve and influence interest rates in the local market, even in the absence of a national currency, by offering a benchmark/reference rate of interest that banks will find it difficult to ignore. These instruments can also contribute to promoting PMA's ability to manage overall liquidity in the system by injecting or absorbing money in or out of the market.

The paper of the **Central Bank of Kuwait (CBK)** refers to the efforts exerted by the central bank to manage domestic liquidity. Amid improving conditions, liquidity absorption by the CBK has increased by 21.0 percent during 2018 compared to 2017. In particular, the share of interventions surged against CBK bonds and related tawarruq, accounting for 51.5 percent of the total absorptions in 2018 compared to 38.9 percent in 2017. In principle, the CBK monetary operations continued to maintain sufficient systemic liquidity while smoothing out fluctuations caused by periodic variations in the volume of funds introduced or withdrawn from the banking system.

The paper highlights the main challenges for CBK implementation of monetary policy including;

- The accuracy of liquidity forecasting: CBK has an underway project to update the liquidity forecasting model to enable more accurate forecasts to ensure better implementation of monetary policy.
- Striking a balance between utilizing liquidity surplus without compromising asset quality: This is a key issue that CBK faces, when and how much liquidity needs to be absorbed in the market, which could be significantly enhanced with an accurate liquidity-forecasting model.
- The fourth industrial revolution and FinTech development: The fast-paced developments in financial technology are reshaping financial markets, in particular, Fintech innovations and the emergence of new payment tools and settlement systems. This poses both a challenge and an opportunity for central banks and supervisory agencies to adjust monetary policy and financial stability frameworks accordingly.

Banque Du Liban (BDL) highlights in its paper the role of the Central Bank in safeguarding the national currency and maintaining financial and economic stability. The conventional and unconventional monetary policies undertaken by BDL have proven their effectiveness and have been recognized as significant drivers of the Lebanese economy.

BDL launched its first stimulus package amounting to USD 1.47 billion back in 2013. These credit incentives, provided through the banking sector, have played a key role in boosting and supporting the numerous segments of the Lebanese economy. During the past seven years, the stimulus packages have amounted to USD 7.2 billion. These incentives, together with the exemption of banks from reserve requirements and government loan subsidies, have led to the injection of almost USD 16 billion to support economic activity since 2009. The importance of these catalyst endeavors lies in their sizable contribution to real GDP, and their momentum in job creation.

Additionally, the BDL was the first institution to foster the Lebanese knowledge economy on a national scale by motivating the banking sector to invest around USD 600 million in startups. BDL has been focusing on developing and supporting Lebanese highly qualified human capital that is capable of effectively turning innovative ideas into successful businesses and creating job opportunities in the process, thus contributing to economic prosperity. Furthermore, BDL has strived to create an adequate environment to promote the banking and financial sectors on the one hand, and the knowledge ecosystem on the other, with the expectation that the government would, in turn, support the creation of the necessary environment for a cross-sectorial and diversified productive economic growth.

On the experience of Arab countries with more flexible exchange rate regimes, the paper of **The Central Bank of Tunisia (CBT),** referred to the significant role played by the monetary policy during the period (2011-2017) to maintain price stability by containing inflation at relatively acceptable levels. However, the persistence of macroeconomic imbalances and additional shocks in 2018 have pushed inflation to high levels. Accordingly, the CBT tightened its monetary policy in 2019. As a first step, the Central Bank of Tunisia (CBT) widened the interest rate corridor to 200 bps while maintaining the cap on the main refinancing transactions. Meanwhile, to preserve the interests of "small savers," the CBT decided to raise the minimum rate of remuneration applied to special savings accounts to 5 percent, as real interest rates became negative with the upraise of inflation.

The persistence of consumer prices at high levels, the depreciation of the dinar combined, and the past wage increases motivated the Central Bank to further raise its key interest rate by 100 basis points in February 2019, bringing it to 7.75 percent. This proactive action, accompanied by targeted communication, has helped to better anchor the expectations of economic agents and gradually reduce pressure on consumer prices in the forthcoming period.

In 2019, The Central Bank established its first three-year strategic plan (2019-2020) with a vision of being a modern, proactive, and efficient bank at the forefront of economic and financial transformations. Under its strategic plan, the Central Bank has set a strategic goal of "Establishing a clear, transparent and credible governance framework to conduct monetary policy".

The recent successful experience of inflation targeting is presented in the paper of **The Central Bank of Egypt**. Within the framework of the Economic Reform Program implemented during the period (2016-2019), the government has undertaken many reform measures, including the liberalization of the exchange rate regime in November 2016. Within this context and in line with its endeavor to ensure price stability, the CBE adopted a tightened monetary policy, announced quantitative inflation targets and target achievement horizons, as well as enhanced transparency. The change of the monetary policy regime to a liberalized exchange rate system, combined with a prudent interest rate policy and strong fiscal consolidation have helped stabilize Egypt's macroeconomic environment.

In this environment, monetary policy was challenged to initiate a disinflation path to achieve its mandate of price stability over the medium term and to contain inflationary pressures from the external and fiscal adjustments that led annual headline and core inflation to peak at 33.0 percent and 35.3 percent in July 2017, respectively. Accordingly, the Monetary Policy Committee decided to raise key policy rates by a cumulative 700 basis points between November 2016 and July 2017 and introduced longer-term auctions for liquidity-absorbing operations. With the containment of inflationary pressures, the Monetary Policy Committee has so far reduced policy rates by a cumulative 450 basis points.

The inflation targets were set on a declining path to achieve price stability while preserving macroeconomic stability. For 2020, Q4, the inflation target was set at 9 percent (±3 percentage points), down from the previous target that was set at 13 percent (±3 percent-age points) for Q4 2018, which marked the first announced target in the history of the CBE, and which was successfully achieved.

Meanwhile, annual headline and core inflation continued to decline to record 8.7 percent and 5.9 percent in July 2019, respectively, the lowest rates in almost four years. This decline was supported by (i) strong favorable base effects due to weaker fiscal consolidation measures compared to the previous year, (ii) an appropriate monetary policy stance that contained inflationary pressures, as well as (iii) governmental supply-side measures.

The paper of **Bank Al-Maghrib** highlights policies undertaken to continue the reform of the exchange rate regime and to establish an inflation-targeting framework at the latter stages of the flexibilization process. This transition will be carried out in an orderly process with a gradual widening of the band of fluctuation of the exchange rate and abandoning the reference basket at a later stage. The pace of the transition will depend not only on the assessment of its prerequisites among which macroeconomic balances and fiscal discipline but also on the ability of the economic agents, mainly export and import oriented enterprises to adapt to the higher exchange rate risk environment.

At an advanced stage, this reform will not be without impact on the conduct of monetary policy. The exchange rate as a nominal anchor would be abandoned, offering more autonomy to monetary policy to achieve its objective of price stability. Under these circumstances, the Central Bank could move towards an inflation-targeting framework. An explicit inflation target in the form of a point or an interval will be fixed and announced. This requires an adaptation of the monetary policy conduct at all levels, governance, instruments, implementation, and communication. The central bank has already started to develop such a framework and has achieved significant progress in this way.

However, to reach its ultimate objective of strengthening the resilience of the economy and support its competitiveness, this transition needs to be accompanied by other structural reforms to enhance productivity and improve the business climate.

In conclusion, the meeting served to give policymakers much food for further reflection. Although specific national circumstances differ, there are many common elements in the formulation of monetary and financial policies so Central banks can learn much from each other.

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AMF - BIS Third Working Party Meeting on

Monetary Policy in the Arab Region

The Hashemite Kingdom of Jordan

The Central Bank of Jordan

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13-14th November 2019

Monetary Policy Implementation in The Hashemite Kingdom of Jordan

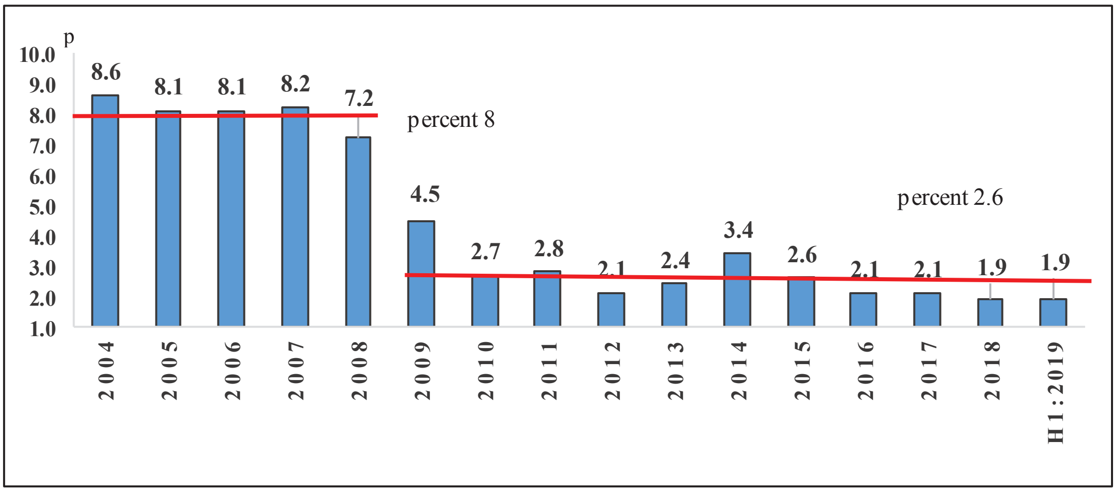
1. Background

Jordan is a limited natural resources country. Lacking oil production makes Jordan highly dependent on foreign energy sources, with 96 percent of the country's energy needs coming from imported oil and natural gas from neighboring Middle Eastern countries. Moreover, Jordan is the third most water-scarce country in the world, while its population is rising at approximately 3 percent annually. Jordan has built the foundation of its economy on a well-educated and healthy labor force.

Following a period of strong economic performance during 2004-2008, with economic growth exceeding 8 percent on average, Jordan's economy has experienced several challenges. The 2008 global financial crisis was the most severe crisis that affected the global economy since the great depression of 1930. as a country that adopted market liberalization and trade openness, Jordan has been affected by this crisis, which reduced the economic growth to 2.7 percent in 2010, and remained, since, at low levels reaching 1.9 percent in the first half of 2019.

After signs of recovery from the global financial crisis began to emerge, the Jordanian economy has been affected by new exogenous shocks. These shocks were related to the political and security turmoil in some neighboring Arab countries, the influx of refugees into the Kingdom, the surge in the energy import bill as a consequence of the repeated interruptions in the flows of the natural gas from Egypt and the rise in the oil prices.

Graph 1: Real GDP Growth Rate in Jordan



Internal conditions in Iraq and Syria has resulted in a deceleration of economic growth rates following the decline of domestic exports, investment inflows, tourism income, and an increase in public debt. The influx of Syrian refugees into Jordan has created a considerable burden on services and infrastructures.

Nevertheless, these challenges did not hinder the political and economic reform process as a road map for inclusive economic development, which focuses on developing the necessary infrastructure of the national economy and raising human resource capacity. Such policies and economic reforms have strived to keep pace with the accelerating international and regional developments while taking into consideration unfavorable developments in the national and external economic environments.

The Central Bank of Jordan (CBJ), on its part, was keen to face these critical situations responsibly and professionally, through using conventional and unconventional monetary tools. This helped mitigate Jordan's economy from the challenges repercussions and achieve the CBJ's primary objective of preserving the monetary and financial stability, with a focus on maintaining the exchange rate stability of the Jordanian dinar, as the nominal anchor of the monetary policy. The CBJ also succeeded in maintaining a sound and robust banking system, greatly capable of withstanding shocks and high risks. Thanks to the high level of capital adequacy which is considered as one of the highest in the region, and the comfortable levels of liquidity and banking profitability.

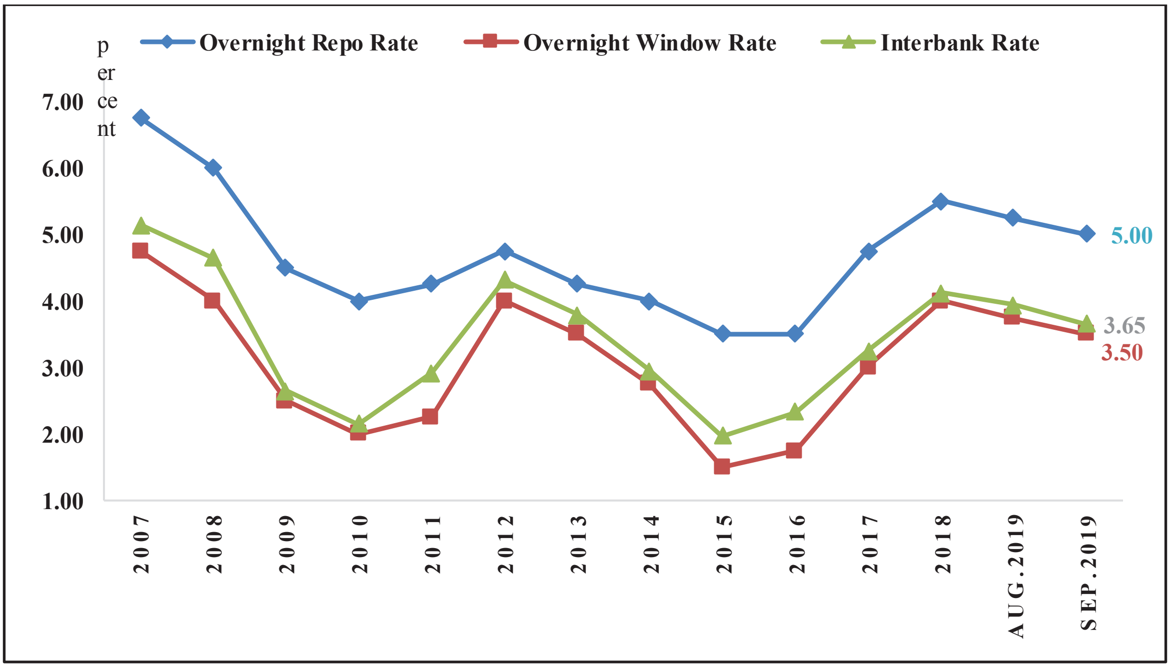
The policies and measures adopted by the CBJ have proven its efficiency in managing crises, whether they were designed to face economic and banking crises or to stimulate economic growth and preserve monetary and financial stability.

2. The Operational Framework of Monetary Policy: The Latest Developments.

The CBJ's statutory mandate is to maintain monetary and financial stability. To meet this mandate, the CBJ adopted the interest rate corridor (IRC) system in implementing monetary policy since 2007. Under this system, there are upper and lower bounds within which the CBJ target interest rate (interbank rate) could move.

The upper bound is the rate at which banks could borrow from the CBJ (the overnight repurchase agreement), and the lower bound is the rate at which banks could deposit their excess money at the CBJ (the overnight window rate). The CBJ's main interest rate (the weekly repurchases agreements) is the benchmark rate by which other policy rates will be determined, hence providing clear signals of the monetary policy stance and its orientation towards local, regional and international monetary and economic developments.

Graph 2: Corridor System in Jordan



Source: Central Bank of Jordan.

From the end of 2016 through 2018, the CBJ raised the interest rates on its monetary policy instruments by 2.5 percentage points to preserve the attractiveness of the Jordanian dinar and maintain the monetary and financial stability in the Kingdom.

Nevertheless, the CBJ has balanced the preservation of monetary and financial stability with the objective of stimulating economic growth. However, while it stands ready to react immediately to ensure that its objectives are met, the CBJ, on the other hand, individually and with cooperation with other entities, introduced many initiatives aiming at improving the SMEs access to finance and encouraging the banking sector to finance the vital economic sectors, thereby improving job creation and economic activity. These initiatives, including:

- The CBJ launching of a realm initiative program to enhance the high value-added sectors of the economy (9 economic sectors), in particular, industry, tourism, agriculture, renewable energy, information technology, engineering consulting, health, education (vocational and technical training) and transportation (transport companies). This program constitutes up to 5 percent of the outstanding loan portfolio of each bank. The loans under this program are with long term maturities up to ten years and with a potentially available fund of JD 1.3 billion.

- The CBJ provided a JD 100 million loan to the Jordanian Loan Guarantee Company (JLGC) to extend and support the expansion of the export credit guarantee program.
- The CBJ, in cooperation with the Ministry of Planning and International Cooperation, has established the Innovative Startups and SMEs Fund (ISSF) to invest in the capital of the emerging projects with an equal contribution in this fund by the CBJ and the World Bank in the amount of USD 98 million.
- In collaboration with the Ministry of Planning and International Cooperation and International financial institutions, the CBJ mobilized around USD 440 million funds for financing small and medium enterprises sector with competitive interest rates and appropriate maturities, and these funds are channeled to SMEs sector through banks.
- Licensed banks also launched two equity funds to invest in existing small and medium-sized companies, one for commercial banks with a capital of JD 100 million and the other for Islamic banks with a capital of JD 25 million.
- Recently, the CBJ launched a JD 100 million fund for the national program of self-employment "INHAD," aiming at providing them with loans through commercial banks at a very low-interest rate. The program supports youth to establish their projects to achieve a permanent income and provides them with employment opportunities.

In 2019, most Central Banks around the world switched to monetary policy easing after spending much of the last few years leaning toward tightening monetary policy. The key drivers for monetary policy loosening are softening domestic outlooks, falling annual growth rates and expectations, low inflation, and weakening business and consumer confidence.

Following the global trend of monetary policy easing, the CBJ cut the interest rates on its monetary policy tools twice in 2019 by 25 basis points each, in August and September 2019. A move aimed at boosting the growth of credit granted to various economic sectors and stimulating domestic spending, both consumption and investment, which will positively affect the rates of economic growth. The decision was prompted by several factors, including the decrease in the inflation level and the expectation that it will remain low in 2019 and the significant improvements in the balance of payment and monetary indicators.

The CBJ succeeded in maintaining the exchange rate stability, and it is fully committed to maintaining the exchange-rate peg since 1995, which has proved its efficiency as the nominal anchor of monetary policy and helped to maintain a comfortable level of foreign reserves. Several internal and external studies, including IMF studies, show that the exchange rate of the Jordanian dinar is broadly in line with its medium-term fundamentals, and the real exchange rate is stable around its long-term equilibrium. There are no noticeable misalignments, which support the effectiveness of the peg exchange rate regime.

3. The Implications of Global, Regional and Internal Economic and Financial Developments on Monetary Policy Implementation

The world economy enjoyed a prolonged period of stability until the eruption of the global financial crisis in 2008, even though its impact on advanced economies was much more profound. This crisis provoked significant economic challenges and enforced new challenges for monetary policy management. Accordingly, many central banks used unconventional monetary policy instruments and reduced interest rates to reach zero or even negative levels to stimulate economic growth.

The CBJ adopted a flexible monetary and banking policy, taking into consideration the domestic and external developments to deal with the repercussions of the crisis on the national economy. In this regard, the CBJ started adopting several expansionary monetary measures gradually since November 2008, from which:

- Reducing the interest rates on monetary policy instruments by 2.75 percentage points.
- Reducing the required reserve ratio on bank deposits three times by one percentage point to reach 7.0 percent.
- Stopping issuance of Certificates of Deposit since October 2008, leaving more space for banks to provide credit for different sectors to support economic growth.

The global financial crisis demonstrated that central banks are the first port of call when systemic financial crises occur and assert the need to contain transmitted risks to the entire financial system with appropriate financial policies. Thus, many Central Banks are focusing on financial stability more than they used to do before the crisis, both in their formulation of monetary policy as well as their macroprudential actions to limit systemic risk.

In this regard, the CBJ established “The Financial Stability Department” in early 2013 with the responsibility of ensuring that the financial system is capable of withstanding shocks through analyzing, evaluating, monitoring, and controlling risks on the macro-level of the financial system, in addition to establishing and executing strategies for dealing with financial crises in order to achieve financial stability requirements. Correspondingly, the

CBJ's law was amended to include "financial stability" along with "monetary stability" to become the primary objective of the CBJ.

Moreover, the CBJ expanded its regulatory umbrella to include the non-banking financial institutions (microfinance institutions), to enhance their role in financing micro, small, and medium enterprises. In addition, the CBJ is heading towards the supervision of insurance companies, which are currently regulated by the Ministry of Industry and Trade.

Another challenge that is currently facing Central Banks around the world is dealing with financial technology developments. Financial technology or "FinTech" has seen remarkable growth over the past few years. FinTech is transforming the financial industry and, consequently, is having a significant impact on the way Central Banks operate towards financial and monetary stability. As a result of this transformation, Central Banks are required to adapt, with a clear strategy capable of responding to a changing world (new agents, different jurisdictions, new business models, etc.). While some central banks will have to revise their legal mandate to achieve this strategy, there seems to be enough room to address technological-driven challenges considering the mandates of price stability, the efficiency of the financial system, and the proper functioning of payment systems.

In this regard, the CBJ has established a FinTech Regulatory Sandbox to support innovation in FinTech and promote entrepreneurship by providing a safe and secure environment for applicants to technically test innovative solutions and to ensure meeting regulatory requirements and propose regulatory amendments if needed.

Noticeably, new risks have emerged, such as cyber risk, and other systemic risks as a result of financial developments and particularly Fintech and digital financial services. New regulatory reforms and accounting standards, such as Basel III and IFRS 9, enhance prudential regulation, yet rigorous monitoring and mitigation interventions are required when needed. It is noteworthy that these developing risks are currently not a significant concern and are contained, since the banking system remains resilient, safe, and sound due to a strong regulatory framework and ongoing monitoring of emerging risks resulting from financial developments.

In the same context, cryptocurrencies have witnessed fluctuations over the last years. Thus, CBJ maintained a cautious approach to observe monetary stability and to ensure the protection of financial consumers in the Kingdom. In 2014, CBJ banned financial institutions from dealing with cryptocurrencies until further notice, yet at the same time announced to the public that CBJ is eager to study and experiment with financial solutions that are based on similar technologies like Blockchain.

In light of the spread of many decentralized cryptocurrencies in many countries and to keep pace with the rapid development of global technology, the Central Banks have a tendency towards issuing a Central Bank Digital Currency (CBDC).

Some economies, especially emerging economies, tended to issue digital currencies (CBDCs) to improve competitiveness and efficiency of operations, therefore, maintaining financial stability and enhancing financial inclusion. They also seek to promote the use of non-cash payment systems to curb and restrict undeclared transactions and crimes such as money laundering, terrorist financing, tax evasion, and illegal activities. Also, the issuance of the CBDCs will reduce the costs of printing and managing cash.

4. Monetary Policy Implementation: Main Challenges and Reforms.

The CBJ has been keeping abreast of developments at the local, regional, and international levels, adjusting the monetary policy framework accordingly. A major shift in monetary policy management occurred in 2007 by introducing the interest rates corridor system, which allows the CBJ to intervene in the monetary market more efficiently and effectively to maintain monetary stability. Within this framework, a new monetary policy instrument was developed, namely, the overnight repurchases operations.

Challenges facing the monetary policy continued, and the CBJ was able to overcome them successfully. The most prominent challenge during the last decade was the outbreak of the global financial and economic crisis in 2008, which affected the whole World economies. As a country that adopted market liberalization and trade openness, Jordan has been affected by the crisis that provoked significant challenges on the economic growth rates and enforced new challenges to manage the monetary policy. The most notable intervention was the reduction of the various monetary policy instruments interest rates by 2.75 percentage points, besides reducing the required reserve ratio on bank deposits three times by one percentage point to reach 7.0 percent. In addition, the CBJ stopped the issuance of Certificates of Deposit since October 2008, leaving more space for banks to provide credit for different sectors.

The Jordanian economy was again challenged by the regional political and economic developments. These crises were related to the rise in the energy import bill as a consequence of the repeated interruptions in the flows of the natural gas from Egypt, the increase in international oil prices. in addition to the influx of Syrian refugees resulted in a decline in domestic exports, the inward investment inflows, and the tourism income. These developments slowed the economic growth rates, widened the financing gap, increased the level of public debt, and imposed many challenges on monetary policy management due to the decline in the official reserves of foreign currencies.

Consequently, the CBJ revised the monetary policy framework twice, through which new instruments were introduced to improve monetary policy efficiency and enabling banks to meet financial needs for different economic activities. The new monetary policy tools were applied in light of the need to inject more liquidity in the national economy.

The first phase, applied in 2012, aimed to create tools to inject liquidity into the economy so that it would be able to cope with the pressures it faced including the influx of a huge number of Syrian refugees, the increase in the energy import bill which imposed high pressures on foreign reserves, as well as the widening deficit in the public budget and the current account. The new framework included three new tools, namely, the weekly (monthly) repurchase agreements facility, the outright open market operations, and the foreign currency swaps. The introduction of these tools aims at increasing the efficiency in conducting monetary policy to provide adequate liquidity to the banking system and minimize the volatility of the interbank market interest rates.

In the second phase, which started in February 2015, the CBJ developed its tools in a manner that helps banks to manage liquidity to meet their operational requirements and respond to the growing financing needs of different economic sectors. This framework gives the CBJ enough flexibility to manage monetary policy tools in a way that achieves its goal of maintaining monetary stability. It also involves issuing certificates of deposit with different volumes and maturities according to the CBJ's pricing. Also, a new interest rate “CBJ main interest rate” is introduced as a reference rate for monetary policy, which currently represents the weekly repurchase agreements rate.

Table 1: Monetary Policy Framework Development

Direct Intervention Monetary Policy		Decision to Float interest rates	Indirect Intervention Monetary Policy	Repurchase of CDs	Overnight window	Corridor system; Overnight Repo	Stop issuing CDs	1st review: Weekly and Monthly Repo, Outright OMO, and Currency Swap.	2nd review: CBJ main rate, issuing CDs in different maturities
1964	1989	1990	1993	1994	1998	2007	2008	2012	2015

Table 2: Monetary Interest Rates Development

Year	Direction	Basis Points	Year	Direction	Basis Points
1967-1972	↓	50	2004-2006	↑	325
1976-1981	↑	150	2007-2010	↓	325
1983-1986	↓	75	2011-2012	↑	200
1988	↑	275	2013-2015	↓	250
1997	↓	75	2016-2018	↑	250
1998	↑	125	Until Aug. 2019	↓	50
1999-2003	↓	612.5			

5. Conclusion

Since the last decade, Central Banks around the world have changed their views regarding how to conduct the monetary policy; hence, an additional objective has been introduced, namely financial stability. Furthermore, Central Banks resorted to unconventional monetary tools, and they developed the operational framework of monetary policy to prevent the occurrence of a new financial crisis. In the same context, the turmoil in the Arab region was a remarkable challenge too, which has significantly affected the Jordanian economy and the monetary and financial stability in the Kingdom.

The CBJ acquired the experience to deal with challenges, whatever their source. The monetary policy carried out by the CBJ is flexible and capable of dealing with the challenges efficiently and successfully. The several updates of the monetary policy instruments, objectives, and decisions to adapt to economic defiance aroused in many stages. Overall, the CBJ succeeded in achieving its primary objective in maintaining monetary and financial stability and preserving a stable exchange rate.

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AMF - BIS Third Working Party Meeting on

Monetary Policy in the Arab Region

The Kingdom of Bahrain

The Central Bank of Bahrain

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13-14th November 2019

Monetary Policy Implementation in The Kingdom of Bahrain

1. Background

The Kingdom of Bahrain is a financial center in the Middle East region for conventional and Islamic finance. The banking sector, which consists of both conventional and Islamic banks, has made a noteworthy contribution for Bahrain to emerge and continue its position as a financial center. As of July 2019, the total assets of the banking sector were about US$200 billion, roughly six times the size of the Gross Domestic Product (GDP). As of July 2019, the conventional banking sector included 25 retail banks, 51 wholesale banks, and 17 representative offices of overseas banks. The Islamic banking sector consisted of 6 retail banks and 15 wholesale banks.

The Central Bank of Bahrain (CBB) is responsible for setting and implementing monetary policy in the Kingdom of Bahrain. Bahrain maintains a fixed exchange rate regime between the Bahraini dinar and the US Dollar. The exchange rate peg provides an anchor for monetary policy. Low inflation and a stable currency are important long-term features of the Bahraini economy, which support a stable business environment and high levels of investment, both domestic and foreign origin.

The CBB monetary policy operations aim to ensure that the liquidity situation in the banking sector is appropriate. The Bahraini Dinar liquidity of the retail banks consists mainly of the current account balances they hold with the CBB. These balances, which can be traded between banks in the money market, fluctuate from day to day, mainly as a consequence of the Government conversions of US Dollars to finance its domestic expenditure, the retail banks purchase of US Dollars from the CBB, changes in the amount of currency in circulation, and changes in the banks' reserve balances with the CBB.

The CBB does not maintain any administrative controls over market interest rates. There are no interest rate caps or floors, and the CBB does not seek to influence the cost and distribution of credit in the economy directly. The private sector is thus free to allocate credit as it sees fit.

2. The Operational Framework of Monetary Policy: The Latest Developments

Bahrain is a country with an open economy with no restrictions on capital movements, foreign exchange, foreign trade, or foreign investment. Since 2001, Bahrain pegged its currency; the Bahraini dinar to the US Dollar (1 Bahraini dinar is equal to 2.659 US Dollars[1]), and this exchange rate peg provides an anchor for monetary policy. As per Article 19 (b) of the CBB Law, the amount of foreign exchange reserve permanently maintained by the CBB in normal times should not be less than 100 percent of the value of the currency in circulation.

The pegged exchange rate regime helped the Bahraini dinar to remain stable, supporting sound macroeconomic management, which is vital to ensure investor confidence in the smooth and effective functioning of financial markets and thereby enable Bahrain to further improve its status as a financial center in the region. The credibility gained by the exchange rate peg has complemented the monetary policy implementation.

Under Article three of the Central Bank of Bahrain and Financial Institutions Law 2006 (the CBB Law), one of the objectives of the Central Bank of Bahrain (CBB) is to set and implement the monetary, credit, and other financial sector policies. According to Article 4 (2) of the CBB Law, the CBB has a duty and power to draw and implement the appropriate monetary policies to achieve the Kingdom's general economic goals and maintain the stability of the Bahraini currency and the monetary system. Accordingly, the ultimate targets of the monetary policy are to support sustainable economic growth while ensuring the stability of Bahraini Dinar and the monetary system.

The CBB Monetary Policy Committee (MPC) that meets every week, closely monitors the local and international economic and financial developments as well as liquidity conditions (vital to the effective transmission of monetary policy instruments towards achieving the ultimate targets). The committee then makes recommendations accordingly to the CBB Board and senior management on appropriate policy measures (including monetary policy instruments and the interest and profit rates on government

[1] According to Royal Decree No 48 issued in December 2001.

debt securities and facilities offered by the CBB) to ensure the achievement of the operational targets of the monetary policy.

Bahrain has a leading position in the Middle East region for offering innovative financial instruments, institutions, and a regulatory framework. One of the main objectives of the CBB in implementing seamlessly integrated Real Time Gross Settlement System (RTGS) – Scripless Securities Settlement System (SSS) in 2007, was to develop the securities market (for both, conventional and Islamic) by offering government securities in scripless form at the primary market and making these securities available in the secondary market for trading, liquidity management (including intraday) and monetary policy operations.

It is the responsibility of each bank to have liquid assets and access to funding sources to meet its obligations as they fall due. Sound and efficient liquidity management of banks, in their day to day operations, has special importance for the Central Bank to carry out its statutory roles to ensure effective monetary policy operations, smooth functioning of payment systems as well as financial system stability.

The objective of this paper is to review liquidity management from a monetary policy stance. Accordingly, the paper mainly elaborates on the liquidity instruments which are made available by the CBB for banks, under its monetary policy operations, to manage their liquidity in normal times and its implications on monetary policy.

The CBB has continued its efforts for developing banking products and services by:

(i) Introducing Shari'ah compliant structure to the Kingdom of Bahrain Government Debt issuances (such as Sukuk-al-ijara & Sukuk-al-salam), which are issued on a regular basis in the SSS System.

(ii) Providing the required infrastructure and tools such as intraday credit (IDC) in the RTGS System and Shari'ah compliant Islamic Sukuk Liquidity Instrument (ISLI) and Wakalah, for Islamic banks to easily manage their liquidity and for the CBB to offer standing facilities, to inject/absorb excess liquidity with Islamic retail banks;

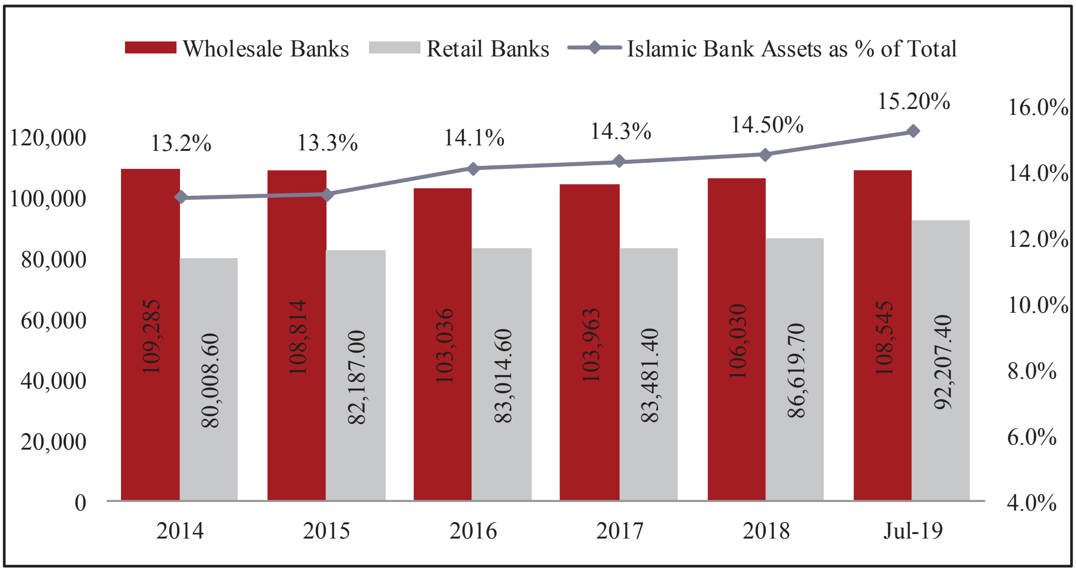
(iii) Introducing easy to use instruments such as Wakalah, that specifically caters to Islamic banks for their liquidity management; and,

(iv) Paving the way for Islamic banks themselves to grow by offering safe and secured Islamic products/instruments.

Islamic banks offer banking products and services in Bahraini dinars or any other currency, in compliance with Shari'ah principles, to residents and non-residents. Such Islamic banking products include restricted and unrestricted investment accounts, Murabaha, Ijara, Mudaraba, Musharaka, Al Salam and Istitsna'a, syndications, and other structures used in conventional finance, which has been modified to comply with Shari'ah principles. In Bahrain, conventional banks as well can offer Islamic banking products and services within their Islamic windows that comply with the respective Shari'ah governance requirements.

Islamic banking has shown significant growth, and the total assets of Islamic banks amounted to USD 28 billion by July 2019. This showed 14 times increase when compared to USD 1.9 billion in 2000. Accordingly, the market share of Islamic banks also increased from 1.8 percent of total banking assets in 2000 to 15.2 percent at the end of July 2019.

Graph 2.1 - Bahrain Banking Sector Asset Composition



Within the Shari'ah framework, Islamic banking needs to be carried out in compliance with the principles of Islamic Shari'ah. Therefore, the success of Islamic banking largely depends on the availability of Shari'ah compliant financial instruments and the required infrastructure that:

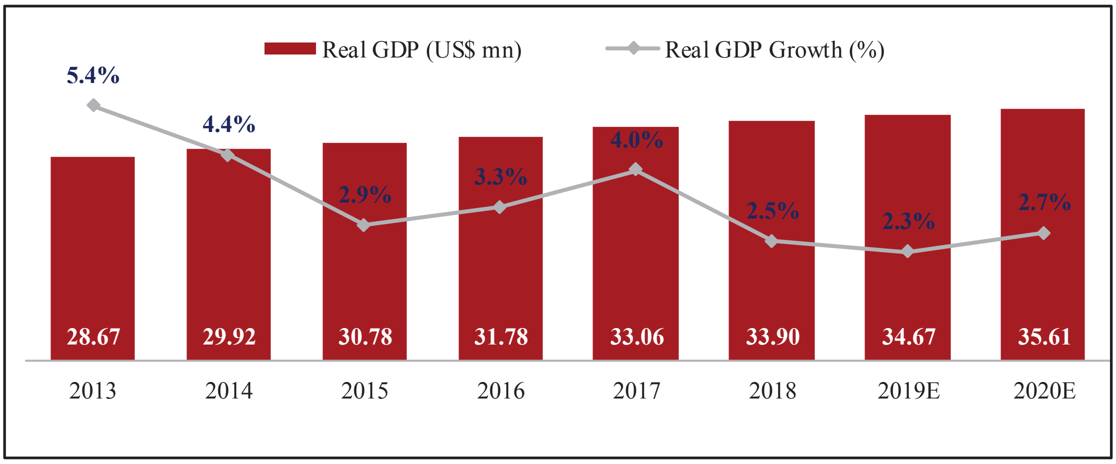
I. Cater to the growing demand for Islamic finance (which can serve more or less similar needs fulfilled by conventional instruments); and

II. Facilitate liquidity management at all levels, i.e., bank, interbank, and central bank level.

Price Stability

The maintenance of the price stability in the economy is vital to promote high levels of economic growth (Please see graph 2.2) and economic welfare while avoiding any adverse impact of prolonged inflation or deflation. Low inflation and a stable currency with the pegged exchange rate are important long-term features of the Bahraini economy, which support a stable business environment and high levels of both domestic and foreign investments. Historically, inflation was not a concern to Bahrain as the level of inflation was stable for more extended period, and fluctuations were moderate.

Graph 2.2 – Real GDP Growth and Forecasts



Monetary Policy Instruments

The CBB uses different types of instruments for the conduct of monetary policy:

1. The Domestic Interest Rates in Bahrain: Key Policy Interest Rates

The CBB key interest rate guides the interest/return rates for its standing facilities provided to retail banks (including Islamic banks), short-term interest rates in the Bahrain money market, and the deposit and lending rates that banks offer to their customers. The CBB policy interest rates prevailed are given in Table 2.1.

The Monetary Policy Committee decides the CBB key policy rates. Key rates are posted daily on the CBB website and the CBB pages on (Bloomberg and Reuters); they are:

- Overnight (O/N) Deposit Rate.
- Overnight (O/N) Wakalah Rate.
- One Week Wakalah Rate.
- One Week Deposit Rate (CBB Key Policy Rate).
- One Month Deposit Rate.
- O/N Repo Rate.
- O/N BD Secured Rate.
- One Week ISLI Rate.

Graph 2.3 – CBB Policy Interest Rates

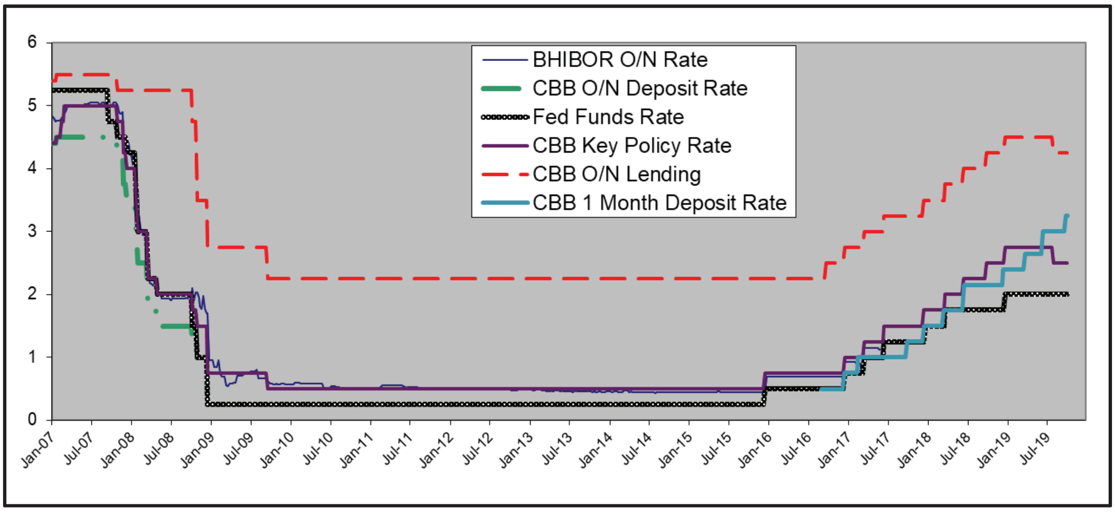


Table 2.1– CBB Policy Interest Rates as of October 2019

No.	Facility	Interest rate (percent)
1	CBB key policy rate (One Week Deposit Rate)	2.50
2	One-week Wakalah rate	2.50
3	Overnight deposit rate	2.25
4	Overnight Wakalah rate	2.25
5	One-month deposit rate	2.85
6	Overnight lending rate (BD Secured)	4.25
7	Overnight REPO rate	4.25
8	One Week ISLI Profit Rate	4.25

2. Exchange Rate Policy

Bahrain maintains an exchange rate peg at 0.376 Bahraini Dinars to the US Dollar. The exchange rate peg provides an anchor for monetary policy, which contributes to controlling inflation and protecting the external value of the currency. The CBB offers a foreign exchange facility, implying that it stands ready to buy and sell US dollars, at rates very close to the official exchange rate. The CBB provides this facility to retail banks located in the Kingdom of Bahrain.

3. Reserve Requirement

CBB requires retail banks to hold unremunerated reserves with the CBB. The reserve requirement system contributes to adjust the CBB's structural liquidity situation vis-à-vis the banking sector. The reserve requirement system is not intended to serve as an active monetary policy instrument for day-to-day liquidity management. All retail banks operating in the Kingdom of Bahrain are required to maintain reserves deposited at the CBB amounting to 5 percent of the value of non-bank deposits denominated in Bahraini Dinars. The CBB determines from time to time the amount and form of the reserves through its Monetary Policy Committee. The required reserves are held at specific reserve accounts at the CBB and cannot be used for other purposes. The CBB calculates the reserve requirement of each retail bank every month from data provided by the banks at the end of the previous month. from data provided by the banks at the end of the previous month. The CBB administers the necessary fund transfers between the retail banks' clearing account and reserve account to ensure that the 5 percent requirement is maintained at all times.

4. Standing Facilities

CBB offers a set of deposit and lending standing facilities in Bahraini dinars to all retail banks. The interest rates on the standing facilities are the CBB policy interest rates. The 1-week deposit rate is the CBB Key Policy Rate. The 1-week deposit rate often constitutes to the midpoint of an interest rate corridor within which short-term market interest rates fluctuate. The overnight deposit rate serves as the lower boundary of the interest rate corridor, and the rate on the lending facilities serves as the upper boundary of the interest rate corridor. The CBB policy rates guide the short-term interest rates in the Bahraini money market and ultimately influence the deposit and lending rates that the banks offer to customers. The standing facilities are a set of deposit and lending instruments. The CBB offers the following standing facilities: Overnight deposit facility

- One-week deposit facility.
- Overnight Wakalah deposit facility.
- One-week Wakalah deposit facility.
- Overnight lending facility against Bahraini dinar deposits at the CBB.
- Overnight repo facility against government securities.
- One-week Islamic Sukuk Liquidity Instrument (ISLI) against Government Ijara Sukuk.

The mechanism of the Islamic Sukuk Liquidity Instrument (ISLI) is based on Sale and Purchase transactions meant to help Islamic banks in managing their liquidity. It involves three separate Sukuk sale and purchase transactions requiring the existence of three parties, namely the Sukuk owner (the bank in need of liquidity), the intermediary bank (the market maker), and the Central Bank of Bahrain (CBB) which offers the liquidity. The standing facilities are available to retail banks, at their discretion, at the end of the daily trading session (after 1:00 p.m.). Access to the 1-week deposit and the One-Month deposit facilities is granted only on Tuesdays (or if Tuesday is a bank holiday, on the following business day).

5. Wakalah

As part of the ongoing efforts towards the development of Islamic banking and promoting investment opportunities for Islamic retail banks, the Central Bank of Bahrain (CBB) launched a new Shari'ah compliant Wakalah investment tool. This tool, which was approved by the Shari'ah Board of the CBB, is aimed at absorbing excess liquidity of the local Islamic retail banking through the Wakalah agreement.

The agreement has been developed, based on a standard contract of the International Islamic Financial Market (IIFM) that is currently used by all Islamic banks in Bahrain. The Wakalah is an investment opportunity for Islamic retail banks who wish to deposit excess liquidity with the CBB. Islamic retail banks need to sign a Wakalah agreement, which appoints the CBB as an agent (Wakil) to invest cash on behalf of the bank (Muwakkil). Accordingly, the Wakil will invest these funds in the investment portfolio allocated in advance and contains international Islamic Sukuks in US Dollars and cash in Bahraini Dinars. The duration of the Wakalah is overnight and one week, which is available for Islamic retail banks every Tuesday.

6. FX SWAP Facility

In 2008, The Central Bank of Bahrain announced a new liquidity measure, which was the 1-week CBB FX SWAP. The FX-swap facility allows eligible counterparties to offer US Dollars against Bahraini Dinars. The facility is available at the request of retail banks on all business days. The CBB went on to adding 1-month, 3-month, 6-month, and 12-month maturities. The amendments in SWAP points are set to assist retail banks in Bahrain to manage their liquidity. They are subject to further terms and conditions that the CBB may impose at its discretion.

3. The Implications of Global, Regional and Internal Economic and Financial Developments on Monetary Policy Implementation

The policy interest rates set by Central Banks have been declining in many countries over the past 20 years as the natural rate of interest in those countries has fallen. A declining natural rate of interest reduces the ability of a central bank to respond to recessions with conventional monetary policy. Understanding the future direction of that rate and the cause of the decline is important for designing effective monetary policy.

The Federal Reserve indicated there would be fewer rate hikes, and eventually resorted to rate cuts, and the reductions in its balance sheet would be more measured. The European Central Bank stooped its bond purchases, announced new long-term loans to banks, and signaled that any rate hikes were unlikely in the near future. The apparent end of the mild tightening cycle, and the possible beginning of a new mild easing cycle—will have several implications.

Some Central Banks have also begun to ease (e.g., the People's Bank of China and the Reserve Bank of India); others would likely follow, or at a minimum, leave interest rates on hold for a while. The lack of further tightening, and in some cases, easing, will help to stabilize growth and limit any further deceleration.

A return to monetary stimulus policy has followed the weaker growth outlook. The US Federal Reserve led the way with a 25 basis points (bps) rate cut at the end of July 2019, followed by an additional 25 bps drop in September and October 2019, to support the financial and commodity markets.

Since Bahrain has free capital movement and adopts a pegged exchange rate regime, the CBB closely aligns the CBB key policy interest rate on the one-week deposit facility to the Fed funds rate. However, the CBB has resorted to fixing its policy rates with a suitable differential in favor of the Bahraini Dinar to manage Bahraini Dinar liquidity in the domestic market. In July 2019, Bahrain also cut rates following the rate cut of the Federal Reserve. In September 2019, when the Federal Reserve decided to cut rates by 25 bps again, Bahrain chose not to, to maintain the favorable differential in rates. The gradual outlook for monetary policy normalization in the U.S. should provide a more accommodative monetary environment for the planned fiscal consolidation in Bahrain.

4. Monetary Policy Implementation: Main Challenges and Reforms

The CBB monetary policy, which operates with a nominal anchor of the exchange rate peg, mainly aims to ensure an appropriate level of liquidity in the banking sector. Islamic banks, as well as conventional banks monitor mismatches of short-term liabilities with their long-term liabilities and manage any prospective mismatches by managing their liquidity.

Like conventional banks, Islamic banks are faced with the challenge of liquidity management to eliminate any prospective liquidity risk[2]. Insufficient liquidity can lead a bank to quickly borrow against its medium and long-term financial assets at an unfavourable rate or sell its assets, even at a loss. Such liquidity problems have the potential to create instability, particularly in the payment system, where difficulty in meeting payment obligations can occur. On the other hand, having excessive liquidity is also costly to the bank. Accordingly, banks are faced with the challenges of efficient and effective liquidity management and maintaining an appropriate balance between insufficient and excessive liquidity.

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[2] According to paragraph 81 of IFSB-1, liquidity risk is defined as “the potential loss to IIFS arising from their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses”.

Having considered the prospective constraints of Islamic banks, the CBB has paid special emphasis to create a level playing field between conventional and Islamic banks to operate in the interbank market and the payment systems (such as RTGS-SSS Systems and retail payment systems) and to use the available tools for liquidity management. The liquidity management tools available for Islamic banks by the CBB are:

(i) Buying and selling Bahraini Dinars against US dollars;
(ii) Buying and selling short-term such as Sukuk-al-ijara;
(iii) Investing excess liquidity in the Shari'ah compliant Wakalah standing facility;
(iv) Obtaining intraday credit (IDC) in the RTGS system; and
(v) Borrowing to cover liquidity shortage using Islamic Sukuk Liquidity Instrument (ISLI).

The retail banks, including Islamic banks, maintain Bahraini Dinar liquidity in their settlement accounts at the RTGS System during its operating hours and thereafter in their clearing accounts at the (BKS), (the CBB's core banking system). The balances in the clearing accounts are swept into the RTGS System at the beginning of the day and are used by banks (conventional and Islamic) to settle their interbank transactions (including money market lending/borrowing) as well as their customer transactions in the RTGS System during business hours. Towards the end of the day, balances in the settlement accounts in the RTGS System are swept out to their respective clearing accounts. The balances in the clearing accounts are not remunerated. Therefore, banks that get excess balances in these clearing accounts largely lend in the interbank money market.

Banks that experience liquidity shortages also largely rely on the interbank money market, which operates very liquid interest-based borrowings. Islamic banks have to use Shari'ah compliant liquid borrowing products/instruments to borrow in the interbank market. One of the key issues is the availability of flexible and liquid Islamic interbank market of a sufficient scale for these instruments to meet the demand of Islamic banks. Creating a dedicated market would not always result in the required market depth. One of the challenges is to bring more and more Shari'ah compliant instruments and infrastructure, including master agreements that could be used by Islamic as well as conventional banks in the interbank money market.

Another challenge is the regulatory requirement for Islamic banks to meet the gradual implementation of the Liquidity Coverage Ratio (LCR) requirements of the Basel Accords. Having considered the absence of a Shari'ah compliant CBB deposit standing facility for Islamic banks and the need to give access to a greater range of zero-risk-weighted assets, in March 2015, the CBB introduced a Wakalah facility, a level-one asset according to Basel definitions. Furthermore, the introduction of one week and overnight Wakalah facilities provided another liquidity management tool for the CBB to conduct its monetary policy with the Islamic banks. Accordingly, since 2015, the continuous participation of Islamic banks in Wakalah was witnessed, and their participation increased to 12.1 percent of the total value outstanding under deposit standing facilities as of September 2019.

The CBB key policy interest is the most important monetary policy instrument. The CBB's liquidity management tools are geared to ensure that short-term interbank money market rates move close to the CBB key policy rate. Accordingly, the CBB sets its policy rates and requirements relating to liquidity management tools with the aim to influence the retail banks' short-term borrowings from deposits at the CBB; and thereby to influence the size of retail banks' balances and reserve money.

The one-week deposit and Wakalah rates are maintained at the same level of CBB key policy rate, while overnight deposit rate and Wakalah rates are set 25 basis points (bps) less than the key policy rate. The one-month deposit rate is set at 35 basis points above the key policy rate. The overnight lending (BD Secured), REPO, and ISLI rates are set at 175 bps above the key policy rate. On the one hand, the liquidity management decisions of Islamic banks have a bearing on the effectiveness of the monetary policy. On the other hand, the Wakalah deposits of Islamic banks correspond to securities used for them by the CBB during the period. Accordingly, Wakalah deposits have a bearing on the CBB assets.

Liquidity management tools available from the CBB under its monetary policy for Islamic banks to manage their liquidity are:

Having considered the Islamic banks' need for Shari'ah compliant liquidity management instrument (that also have a bearing on the liquidity level of the Islamic banking sector), the CBB made available the following liquidity management tools in conducting monetary policy operations:

i. Selling or buying Bahraini dinars against US dollar to/from the CBB:

The CBB's monetary policy accommodates the banks' Bahraini Dinar liquidity needs mainly by buying/selling US Dollars at the official buy and sell exchange rates. These US Dollar purchases/sales have a bearing on the liquidity positions at the clearing accounts of banks at the CBB and thereby on the monetary base (MO).

II. Shari'ah compliant Wakalah standing facility to manage excess liquidity:

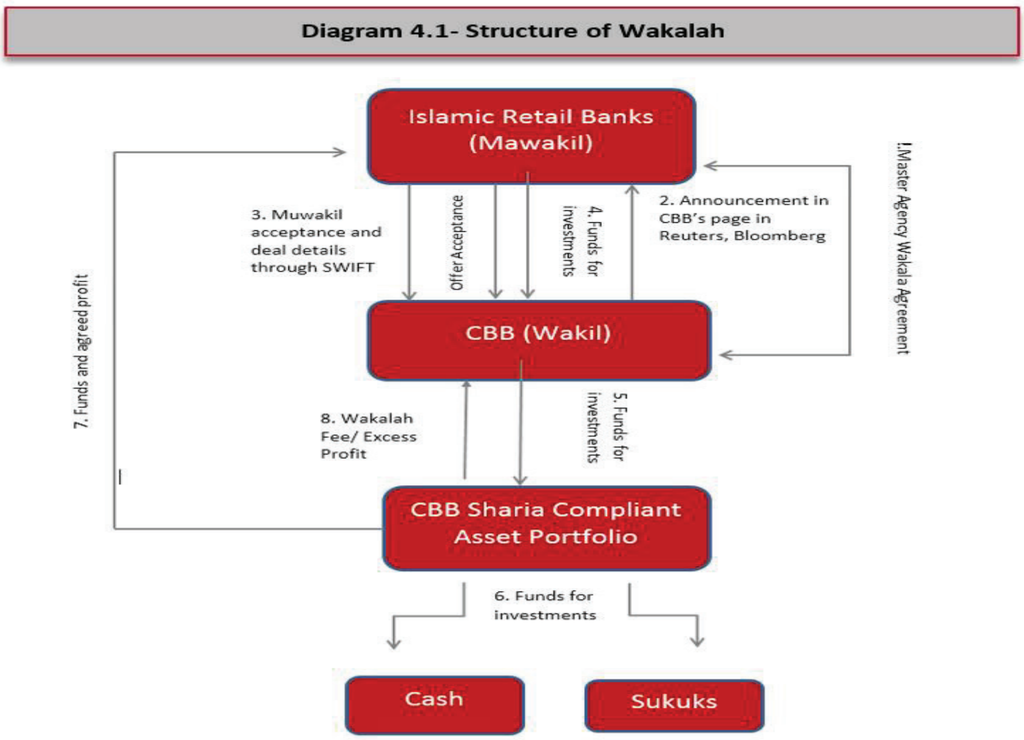
In the absence of standing facilities similar to those of conventional deposit facilities, Islamic retail banks had a high level of excess liquidity parked at their clearing accounts in the CBB at zero profit. The Wakalah one-week facility was introduced in March 2015 to help Islamic retail banks to manage their excess liquidity.

The one-week Wakalah (offered every Tuesday) became popular among Islamic banks as a short-term liquidity management tool to manage their excess liquidity. Having considered the high demand, for the overnight facility, the CBB decided to offer overnight Wakalah facility on business days in June 2017.

All licensed Islamic retail banks are eligible to avail of this facility, and the contract used in this facility is based on the International Islamic Financial Market (IIFM) Master Agency (Wakalah) Agreement, which is recognized and used by the Islamic banks operating in Bahrain. The agreement appoints the CBB as the Wakil and the Islamic banks as the Muwakkil. The structure is provided for a segregated pool of assets that are defined in terms of size, yield, and composition on a regular basis. The pool of assets consists of defined Shari'ah compliant Islamic Sukuks and Bahraini Dinars in the form of cash. The profit rates offered are approximately equivalent to the CBB policy rates to conventional retail banks.

Each retail Islami bank which intends to use the Wakalah facility signs a Wakalah agreement, which appoints the CBB as an agent (Wakil) to invest in a portfolio of eligible securities and cash on behalf of the Islamic bank (Muwakil). The CBB (Wakil) announces the Wakil's offer on its pages on Reuters and Bloomberg. The offer contains the issue/maturity date and the expected profit rate (see Diagram 4.1).

Graph 4.1 – Structure of Wakalah



Retail Islamic banks wishing to place their excess liquidity at the CBB, will send to the CBB an acceptance to the offer. The communication should include the placement value, the profit rate, and the issue and maturity dates. The CBB invests these funds in the investment portfolio (which contains Islamic Sukuks and Bahraini Dinars in the form of cash) in advance. On the maturity date, the CBB returns the funds, plus the earned profit, less the administration fees (BD1 per transaction) to the Islamic bank (Muwakkil).

ii. **Islamic Sukuk Liquidity Instrument (ISLI):** ISLI was introduced by the CBB in 2008 to help Islamic banks (that are direct members of the RTGS-SSS Systems) to obtain liquidity against their short and long-term Sukuk-al-ijara holdings (denominated in Bahraini dinars) in their securities accounts at the SSS System.

An ISLI transaction (one-week) involves:

1. **Dual level (first and second level) of matching and confirmation with three parties**:
    - Sukuk owner (the Islamic bank that needs liquidity);
    - Intermediary bank (the market marker);
    - The CBB, which will offer the bank the required liquidity.

2. **Three separate Sukuk sale and purchase transactions**:
   - Bank A (seller/Sukuk owner): sells the Sukuk to Bank B (market maker) and receives the liquidity needed (both banks should be direct members of the RTGS-SSS Systems).
   - Bank B (market maker): sells the Sukuk to the CBB, the second purchaser, which offers the required liquidity;
   - The CBB (that offers liquidity) at maturity, sells back the Sukuk to Bank A (the first seller and owner of the Sukuk).
   - Two separate agreements:
   - a repurchase agreement between the direct member that sells the Islamic securities to the CBB through the market-maker; and
   - an undertaking or promise of the direct member (that sold the Islamic securities) to buy back the Islamic securities from the CBB at the end of the repo period.

iii. **Short-term ijara Sukuk and Sukuk-al-salam**:

The CBB issues on behalf of the Ministry of Finance and National Economy the following short-term government debt securities via auctions in the SSS System, as per the issuance calendar published in advance in the CBB official website and CBB page at the Bloomberg and Reuters. The government debt securities issuances also have supported liquidity management for Islamic banks.

1. Short-term Sukuk-al-salam (non-tradable) securities that represent a commodity (residue gas) owned by the government and issued to finance development projects every month with a three-month maturity; and
2. Short-term Sukuk-al-ijara (tradable) sale and lease back securities that represent assets owned by the government and issued on a monthly basis, with a six-month maturity.

iv. **Intraday credit facility (IDC) available to Islamic banks in the RTGS System against their tradable Islamic securities holdings (Sukuk-al-ijara) in the SSS System**. Since all Islamic retail banks are members of the RTGS & SSS Systems, they are eligible to get automated IDC (by providing a one-time standing instruction to the CBB, which specify the type of Islamic securities to be used and the amount) at a zero cost, to manage liquidity efficiently during RTGS-SSS System operating hours.

v. **Unremunerated reserves that the Islamic retail banks have to maintain with the CBB.** All Islamic banks must maintain a minimum cash reserve balance with the CBB, set as a ratio of their total non-bank Bahraini Dinar deposits, whether placed by way of call or unrestricted investment accounts (or similar), as well as taken through the issuance of Bahrain Dinar denominated Islamic investment certificates.[3] Currently, all Islamic retail banks are required to maintain a 5 percent of their customer (resident and nonresident) Bahraini dinar non-bank deposits. The reserve requirement is not considered as an active monetary policy instrument for day-to-day liquidity management, and its main purpose is to address structural liquidity issues.

5. Conclusion

Bahrain has a free market economy, with no restrictions on capital movements, foreign exchange, foreign trade, or foreign investment. The Kingdom has a leading position in the region as an open, free, transparent, and welcoming environment for investors. The monetary policy framework is geared to support the general economic goals of the Kingdom.

The global decline in interest rates has been a shift in the monetary policy stance of many Central Banks. This has led to further monetary policy reassessment on Bahrain's end by deciding to cut rates in July but restraining to do so in September to ensure benefit from a rate differential it historically always had.

Bahrain, as a financial center in the region, has geared to promote the growth of the financial sector in numerous ways to cater for the increasing investor demand for Shari'ah compliant financial products and services. The CBB has pioneered in addressing challenges faced by the banks paved the way for Islamic banks to introduce Shari'ah compliant financial instruments, banking products/services. The CBB has created a level playing field between Islamic and conventional in its liquidity management tools available for banks and its payment infrastructure.

Furthermore, the CBB has endeavored in its CBB regulatory requirements to ensure that licensed Islamic banks follow:

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[3] LR-2.5.10 of the RuleBook of Central Bank of Bahrain-Volume 2.

(i) The Islamic Shari'ah principles, standards and guidance notes of the Islamic Financial Services Board and operate under the Shari'ah framework; and

(ii) International best practices and standards applied to conventional financial institutions; and

(iii) Guiding principles on the conduct of business for institutions offering Islamic financial services.

Having considered these challenges, the CBB introduced Shari'ah compliant liquidity management tools such as ISLI and Wakalah, for Islamic banks, to use in their liquidity management via the same infrastructure used by conventional banks. Islamic banks, as a sector, are still faced with challenges to evolve by having more liquid instruments and to deal with domestic as well as international financial markets easily. The magnitude of the challenge on liquidity risk management depends on a number of factors, including the following:

(iv) Easy access to a wide array of Shari'ah compliant, easy to use, liquid instruments (to place funds or raise funds) where necessary to efficiently manage liquidity to the satisfaction of Islamic banks in the domestic as well as international financial markets;

(v) Availability of a flexible and liquid interbank market of a sufficient scale for these instruments to meet the demand of Islamic banks;

(vi) Availability of a flexible and liquid Islamic secondary market of a sufficient scale for Shari'ah compliant liquidity management instruments;

(vii) Availability of adequate Shari'ah compliant liquidity management instruments from the central bank; and

(viii) Fair access to interbank payment and securities settlement systems with intraday liquidity management instruments against Islamic securities.

Central Bank Background Papers on Monetary Policy Frameworks in the Arab Countries

AMF - BIS Third Working Party Meeting on

Monetary Policy in the Arab Region

The Republic of Tunisia

The Central Bank of Tunisia

Prepared by

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Monetary Policy Implementation in The Republic of Tunisia

1. Background

In Tunisia, the monetary policy has been conducted in a turbulent context since the 2011 Revolution. Since that time, the Tunisian economy has had to deal with a number of shocks, both domestic and external ones. The prolonged political transition combined with important fallouts of the crisis in neighboring countries, have had strong negative consequences on the national economy.

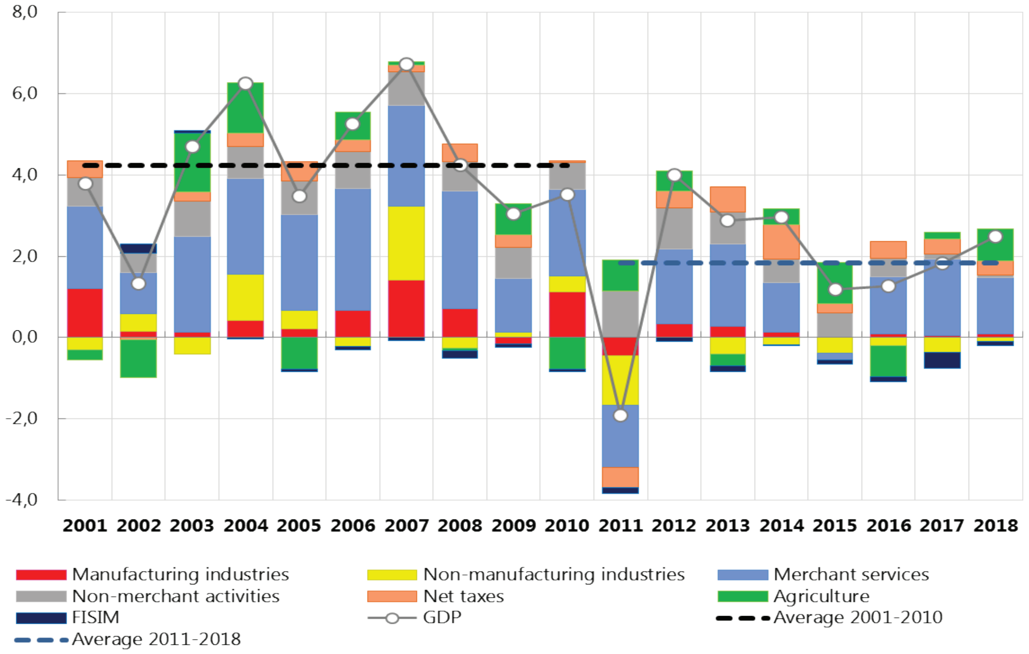
The conduct of monetary policy was not an easy task. It faced many challenges, especially as the preservation of price stability - the main objective of each Central Bank - was not guaranteed with the succession of those internal and external shocks and the accentuation of economic imbalances. In recent years, the main challenge for monetary policy was to curb inflationary pressures and contribute to restoring healthy, sustainable, and inclusive growth.

2. The Implications of Global, Regional and Internal Economic and Financial Developments on Monetary Policy Implementation

The Tunisian economy was faced, in 2018, with an international context marked by accentuated instability of the geopolitical environment, rising protectionism, and volatile raw materials' prices and financial markets. Added to all this, the normalization of monetary policies in the major advanced countries, with the Federal Reserve's pursuit of monetary tightening cycle and start-up by the European Central Bank of the gradual reduction of its securities purchases, without giving an end to its high level of monetary support.

At the national level, 2018 was marked by a gradual strengthening of economic growth, thanks to good performance by the agricultural sector and the sounder evolution of tourism. This led to better growth quality compared to previous years. However, persisting difficulties in the extractive sectors and the weakness of foreign demand have meant that export-oriented sectors, formerly providers of foreign currency, did not perform well.

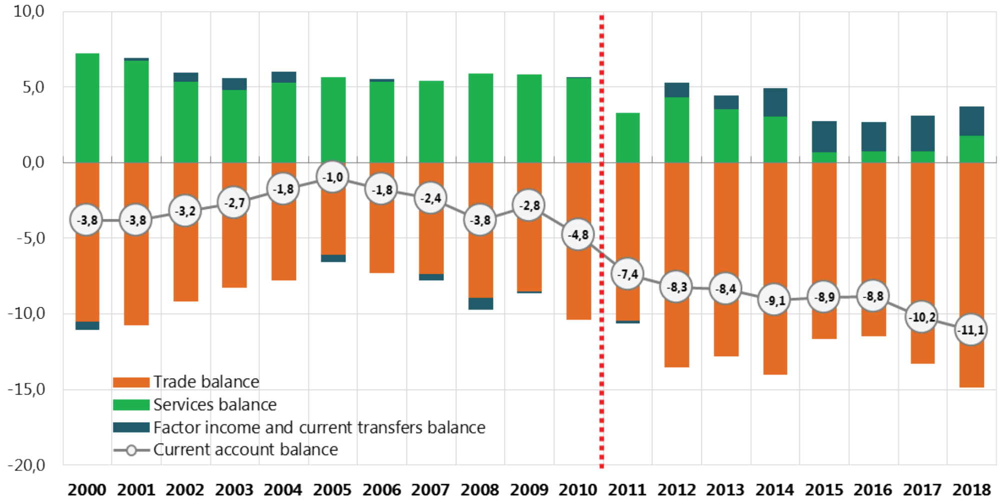
Chart (1)
Sectoral Contributions to Growth



Despite this gradual recovery, the outlook for economic activity, for 2019, would remain moderate. The rise of uncertainties around activity in the Euro Zone, Tunisia's main trading partner, and the persistence of internal fragilities, would be the main impediments to growth in 2019.

The sluggishness of the economic situation was accompanied by a slippage of the current account deficit (11.1 percent of GDP in 2018 compared to 10.2 percent in 2017) resulting from an unprecedented trade deficit, driven in particular by the increase in the energy bill. Nevertheless, the balance of services and transfers has somewhat contributed to easing pressure on the current account.

Chart (2)
The Evolution of the current account balance (In percent of GDP)



The worsening of the current account deficit has led to an erosion of foreign exchange reserves and increased pressure on the dinar exchange rate.

Chart (3): FX reserves

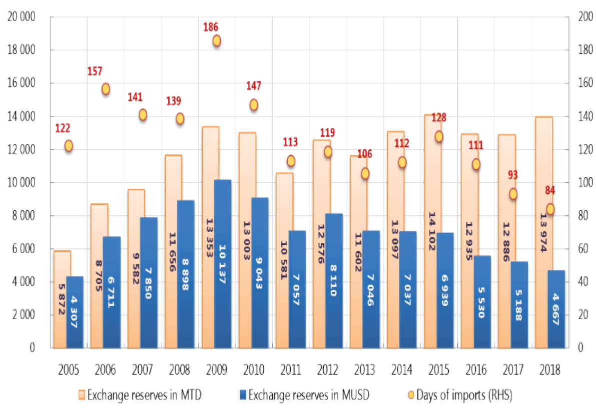
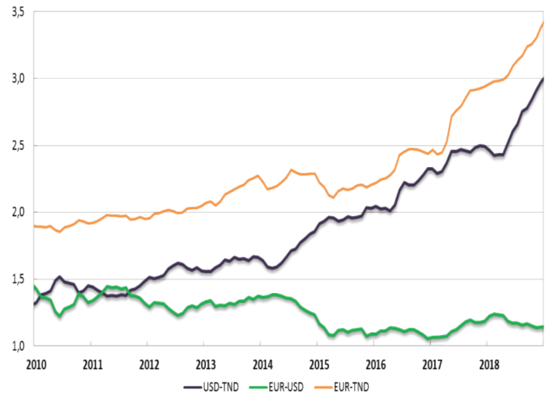


Chart (4): Exchange rates



In addition, the fiscal consolidation policies led to higher tax rates (VAT, consumer duties, and excises).

Chart (5): Trends in fiscal balance
(In percent of GDP)

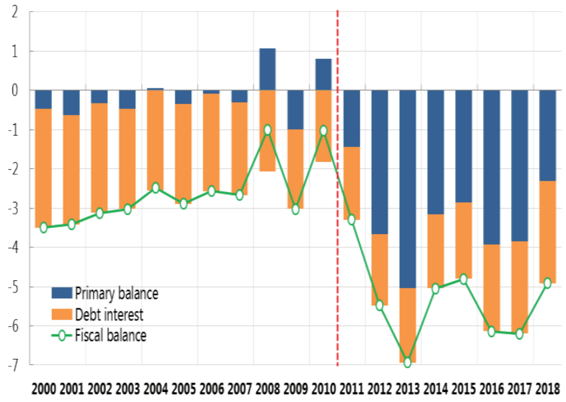
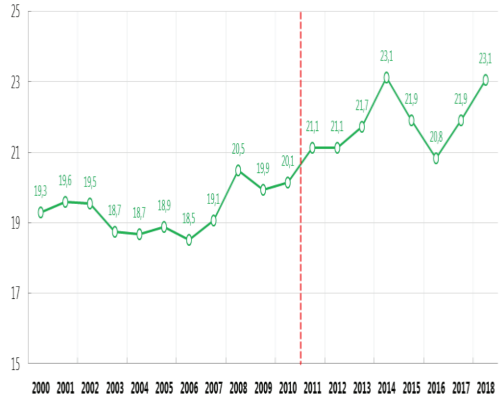


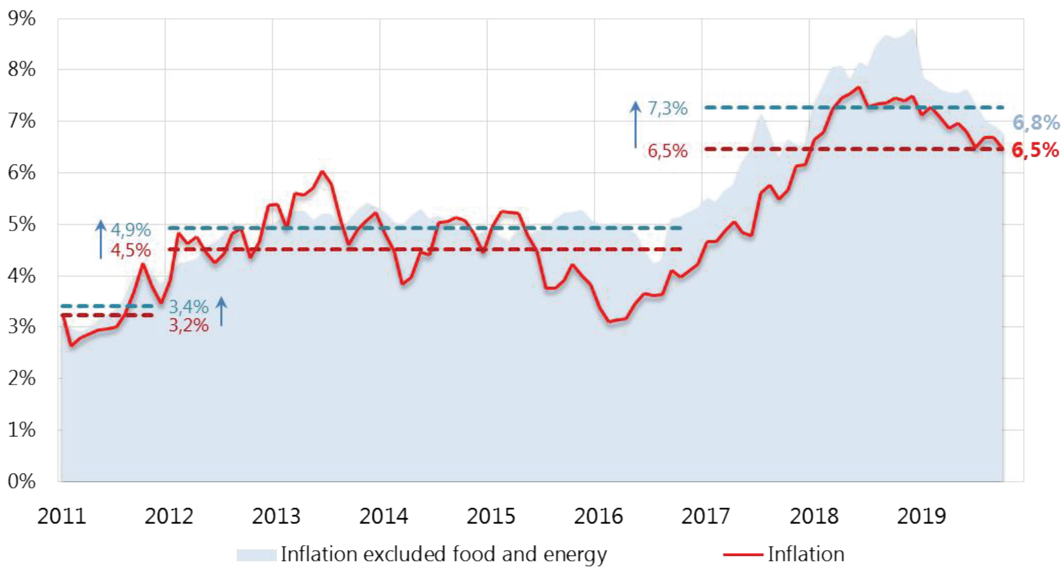
Chart (6): Tax burden
(In percent of GDP)



The worsening of the twin deficits (current account and budget deficits) has strongly affected the macroeconomic balances and increased inflation.

Price pressures continued throughout 2018 while firming up. The average annual inflation rate came to 7.3 percent, compared to 5.3 percent the year before. Indeed, the slippage has been felt since the beginning of the year, and the rate of inflation went quickly beyond 7 percent in March, peaking at 7.7 percent in June, its highest level over more than two decades.

Chart (7)
Headline inflation and core inflation



3. The conduct of Monetary Policy: Recent developments

Anticipating the rise in inflation, the Central Bank, whose mandate is to preserve price stability, has tightened its monetary policy. As a first step, the Central Bank of Tunisia (CBT) widened the interest rate corridor to 200 bps while maintaining the cap on the main refinancing transactions. This measure was meant to create more volatility of the interest rates, which, given the shortage of liquidity, would boost interbank rates to the ceiling of the corridor, a manner to tighten conditions of refinancing on the money market.

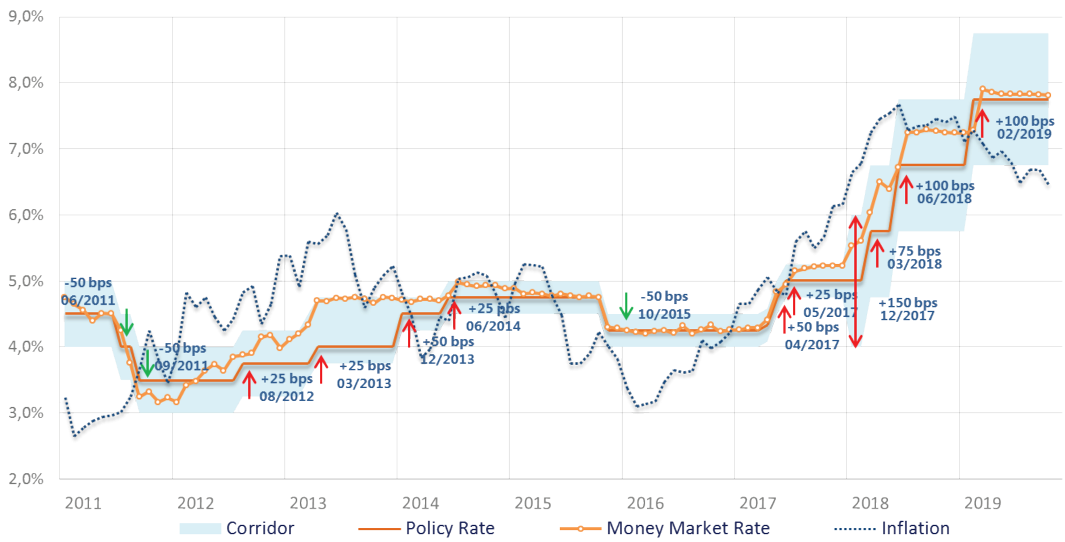
Meanwhile, to preserve the interests of "small savers", the CBT decided to raise the minimum rate of remuneration applied to special savings accounts to 5 percent, as real interest rates became negative with the upraise of inflation. By these actions, the Central Bank has issued a clear signal on its appreciation of the stance of monetary policy best suited to the short and medium-term prospects of inflation, warning signal of an imminent rise in the key interest rate, the increase of which was decided in March 2018 (+75 bps) followed by a second increase (+100 bps) in June 2018, bringing the key rate up to 6.75 percent.

The persistence of consumer prices at high levels, supported by tensions on international commodity and energy prices, and the effects of the depreciation of the dinar combined with past wage increases (with their impact on production costs) motivated the Central Bank's decision to further raise its key interest rate by 100 basis points in February 2019, bringing it to 7.75 percent. This proactive action, accompanied by targeted communication, has helped to anchor the expectations of economic agents better and gradually reduce pressure on consumer prices in the forthcoming period.

At the same time, the Central Bank ensured greater consistency in its intervention instruments on the money market by reducing the outstanding amount of foreign exchange swaps used for monetary policy purposes (which were basically meant as one-off liquidity provision operations). Also, starting from 5 December 2018, the Central Bank introduced a new longer-term refinancing operation (6 months) for banks granting medium-and long-term loans to finance investment projects in productive sectors. On the other hand, and with the aim of further directing banks towards financing the productive sectors, supporting growth and streamlining recourse to refinancing, the Central Bank introduced a new breakdown of refinancing collaterals by requiring a fixed 40 percent portion in the form of negotiable public securities and 60 percent portion in claims on the private sector.

At the prudential level, and to ensure better adequacy between resources and uses, which would make it possible to control the risk of maturity transformation, the Central Bank has established a "Loan to Deposit" ratio [4]. To this end, banks whose "Loan to Deposit" ratio is at a level above 120 percent at the end of a given quarter, are required to take the necessary measures to reduce the rate by two percentage points at the end of the following quarter till bringing it to the desired level.

Chart (8)
Monetary Policy Stance



Thanks to the package of measures covering monetary policy and financial stability areas, the money market rate was maintained above the key rate, rising

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[4] Circular 2018-10 of November 1st, 2018.

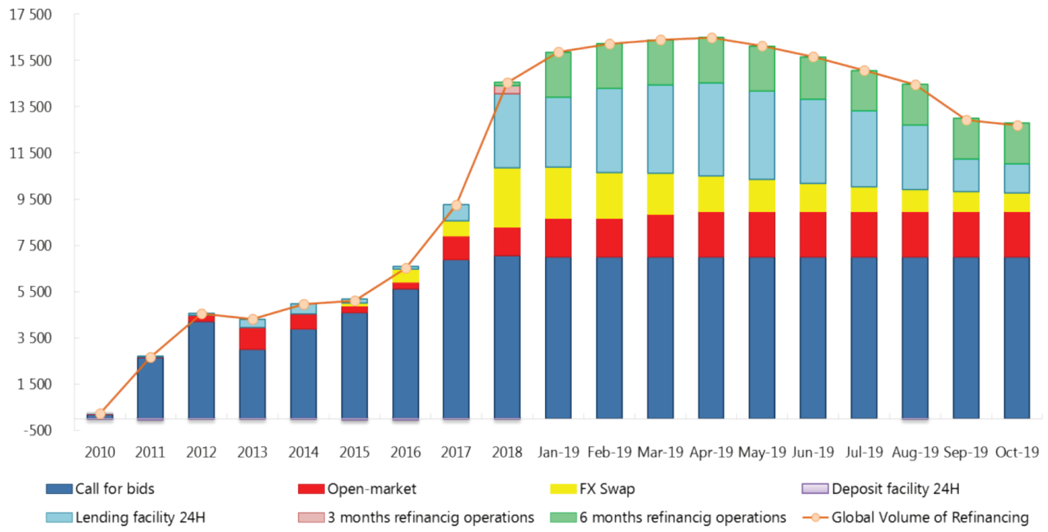
from 5.23 percent at the end of 2017 to 7.24 percent in December 2018, before stabilizing at around 7.83 percent in the second and the third quarter of 2019.

On the liquidity side, the overall volume of refinancing increased steadily since the 2011-Revolution, as a consequence of economic activity worsening, especially since 2015. Deteriorating current account balance (which traduces the impact of a huge trade deficit) increased since then the pressure on net foreign assets and on the Tunisian dinar, impacting sharply banking liquidity.

Furthermore, the persistence of a number of difficulties in State-owned enterprises (SOEs), which have been previously net providers of liquidity to the economy, then turned to be a net user of liquidity, contributed a lot in banking liquidity worsening.

In sum, the overall volume of refinancing jumped from TD 2.674 million in 2011 to TD 6.520 million in 2016, then to TD 14.542 million in 2018 before peaking up to its highest of TD 16.912 million in early May 2019.

Chart (9)
Trends in monetary policy operations



Since then, the overall volume of refinancing embarked on a downward trend. It benefited from the appreciation of the Tunisian dinar (mainly due to an abundant influx of tourism revenue and from the tightening of monetary policy since 2017) and lower oil prices on the commodities market. Its lowest level of TD 11.502

million was reached at the end of November 2019. The increasingly restrictive stance of monetary policy, combined with a drying up of liquidity, quickly spread to bank rates. The relative quick speed of transmission [5] was favored by the practice of indexation of most lending rates to the money market rate (MMR).

Chart (10): Evolution of lending rates to households (levels in percent)

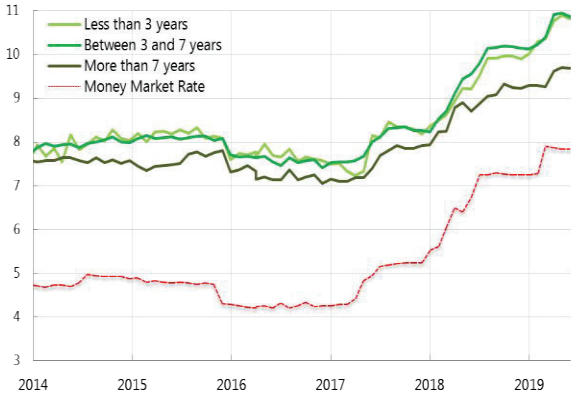
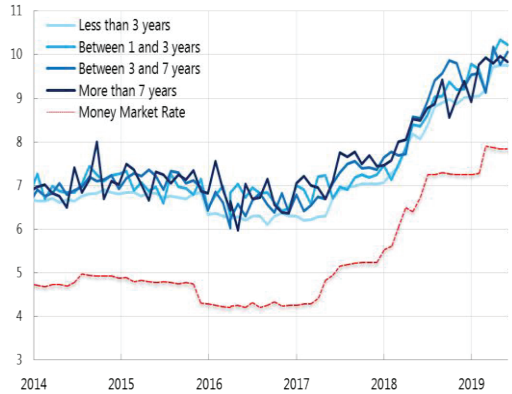
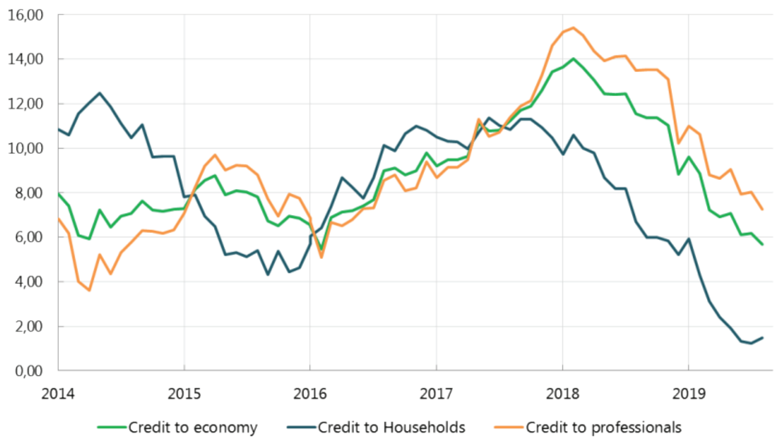


Chart (11): Evolution of lending rates to private enterprises (levels in percent)



As a result, credit to the economy (for both households and professionals) has been affected by the restrictive stance of monetary policy, the objective of which is to constrain the ability of economic agents to spend, and subsequently limiting demand, mainly for consumption, and to contain, therefore, pressure on consumer prices.

Chart (12)
The Evolution of the credit to the economy (yoy in percent)



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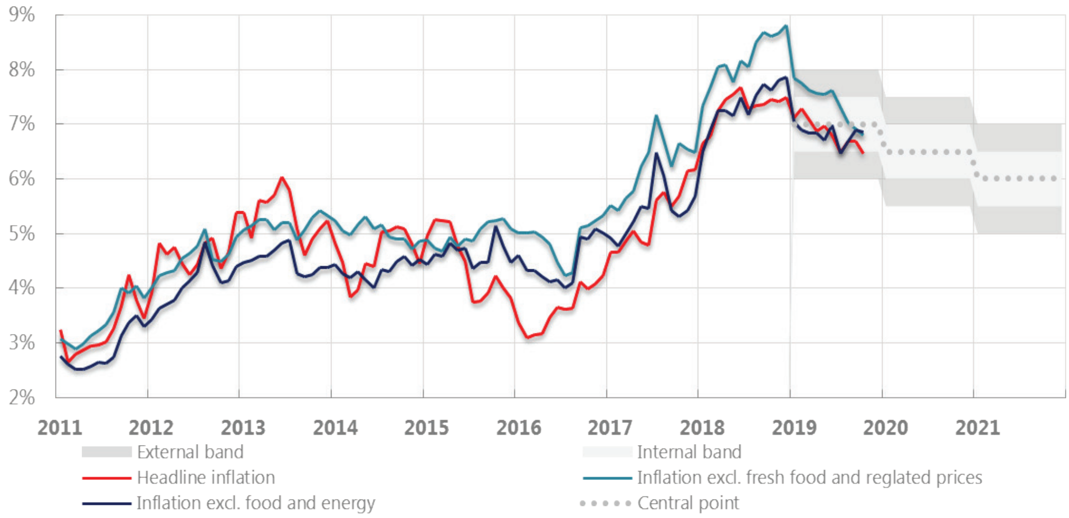
[5] Econometric estimates have shown that the pass-through of the interest rate is between 2 and 4 months.

The slowdown in demand helped to ease the pressure on inflation, which was on a disinflationary trajectory, reaching 6.5 percent in October 2019, compared to 7.5 percent a year earlier. The Central Bank expects an average rate of 6.8 percent for inflation for the whole year, 2019, against 7.3 percent in 2018. By maintaining a restrictive stance of monetary policy, the Central Bank intends to gradually bring inflation back to its long-term average, then contributing to restoring macroeconomic balances.

Chart (13)
Headline inflation and core inflation



To sum up, we can say that:

- Monetary policy has played a crucial role during the 2011-2017 period in maintaining price stability by containing inflation at relatively acceptable levels,
- The persistence of macroeconomic imbalances and additional shocks in 2018 have pushed inflation to high levels and is likely to persist and deviate from historical levels, in the absence of appropriate monetary policy actions,
- The multiplicity and concomitance of exceptional shocks during this period makes it difficult to identify the effects of monetary policy,

- The Central Bank's effort would focus on a targeted communication policy to better anchor the expectations of economic agents and make monetary policy more effective in achieving its objective.

4. Monetary Policy Implementation: Main Challenges and Reforms

In 2019, The Central Bank has established its first three-year strategic plan 2019-2020 with a vision of being a modern, proactive, and efficient bank at the forefront of economic and financial transformations. Under its strategic plan, the Central Bank has set a strategic goal of "Establishing a clear, transparent and credible governance framework to conduct monetary policy".

For this purpose, the Central bank is currently finalizing preparations for the launch of a project whose objective is to enhance the strategic and operational framework of monetary policy in line with the best international standards and practices. This would focus essentially on the following aspects:

- Implementing a clear strategy for the conduct of monetary policy.
- Establishing a governance framework in line with international standards.
- Formalizing the decision-making process.
- Organizing the forecasting policy analysis system (FPAS).
- Establishing a communication device for monetary policy.

Other actions will also focus on the operational aspects of the conduct of monetary policy to devote the interest rate as a privileged instrument to carry monetary policy.

Central Bank Background Papers on Monetary Policy Frameworks in the Arab Countries

AMF - BIS Third Working Party Meeting on

Monetary Policy in the Arab Region

The Kingdom of Saudi Arabia

The Saudi Arabian Monetary Authority (SAMA)

Prepared by

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Abu Dhabi, United Arab Emirates
13-14th November 2019

Monetary Policy Implementation in The Kingdom of Saudi Arabia

1. Monetary Policy Framework and Economic Conditions

The Monetary Policy in Saudi Arabia is anchored by a fixed exchange rate to the U.S. Dollar. SAMA (Saudi Arabian Monetary Authority) remains committed to the fixed exchange rate as its monetary policy objective that aims to maintain the stability of the monetary and financial system to support economic growth. Due to the peg, there is a need for alignment between the policy rates of SAMA and the U.S. Federal Reserve.

Therefore, money market conditions in Saudi Arabia are influenced by U.S. market developments. Because of SAMA's monetary policy framework and prudent macro-prudential policy, SAMA was able to weather various challenges over the past two years.

Saudi Arabia's gross domestic product (GDP) grew by 2.2 percent in 2018, following a slight contraction in 2017. This recovery was mainly attributable to the oil sector, which increased by 2.9 percent. The non-oil sector grew by 1.7 percent in 2018, a rate that was higher than in the previous year. Inflation, as measured by the consumer price index, witnessed a rise during 2018, recording a 2.5 percent increase, mainly due to the introduction of several fiscal measures such as the value-added tax and energy prices reforms. Given the influence of these measures on fiscal revenues, the fiscal stance improved, and the budget deficit decreased to 4.6 percent in 2018, compared to 9.3 percent in the previous year.

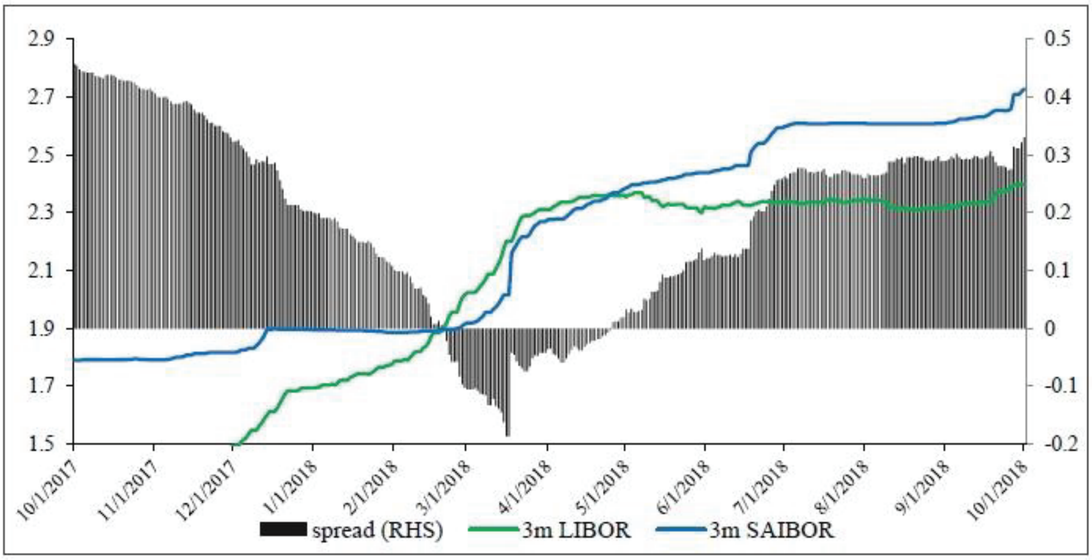
Following the OPEC agreement with other oil-producing countries (OPEC+) in November 2018, Saudi Arabia started reducing its oil production and exports, to stabilize prices. However, oil prices still came down in the wake of declining global growth. As a result, Saudi oil GDP growth in the first half of 2019 was lower compared to the same period last year recording, 1.06 percent. Notwithstanding continued solid growth in the non-oil sector, overall GDP growth slowed considerably. The annual rate of inflation turned negative in 2019, as the impact of the fiscal measures introduced at the beginning of 2018 has faded out. Moreover, the decline in the sub-component "housing and utilities" continued as the result of the departure of expat workers put downward pressures on the cost of rentals for housing.

2. Monetary Policy Developments

In line with SAMA's objective to maintain monetary stability based on current and evolving developments in the domestic economic and financial markets, SAMA has gradually raised the repo and reverse repo rate four times by 25 bps each in 2018. However, in 2019, SAMA has reduced the repo and reverse repo rates twice by 25 bps to reach 2.5 percent and 2 percent respectively against the backdrop of a slowing economy and in conformity with SAMA's objective of preserving monetary stability.

In early 2018, the USD LIBOR curve had been increasing steadily in anticipation of the Fed's policy rate changes and the prevailing market conditions, while SAIBOR (Saudi Arabian Interbank Offer Rate) remained stable. This has resulted in a negative interest rate differential between the SAIBOR and LIBOR rate, as shown below.

Chart (1): 3M SAIBOR Vs. LIBOR



Source: Saudi Arabian Monetary Authority.

Consequently, SAMA took several measures to sustain monetary stability including, (i) the suspension of the term repo facility[6] and (ii) gearing its monetary policy operations toward reducing the liquidity levels. These measures led the SAIBOR to increase. Since LIBOR started to stabilize, the interest rate premium of SAIBOR was restored.

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[6] Term repo was introduced by SAMA in 2016 to address system liquidity shortages and influence interbank rates.

Additionally, to support the bank's liquidity management, in January 2019, SAMA has allowed for "Reserve Averaging" for the statutory reserves based on the average daily balance of the reserve for a maintenance period of one month. Moreover, to better align the liquidity reserve ratio with Basel's Liquidity Coverage Ratio, SAMA requires the recognition of the statutory deposits in the calculation of the Liquidity Reserve Ratio[7] (currently the requirement is 20 percent). These adjustments should give banks more ability to managing their liquidity more efficiently.

3. Banking Sector and Capital Market Developments

The banking system remains well-capitalized, As of Q4 2018, the Liquidity Coverage Ratio (LCR) stood at 211 percent, the Capital Adequacy Ratio (CAR) at 20.54 percent and the Net Stable Funding Ratio (NSFR) at 128.14 percent. These values reflect the liquidity resilience of the banking sector to withstand short and long-term liquidity stress. In Q4 2018, total bank credit grew by 2.7 percent QoQ, mainly driven by a pickup in the retail sector. As of Q2 2019, the CAR had decreased slightly to 19.6 percent (90 percent of which is in the form of Tier 1 capital), whereas the LCR and the NSFR had increased further to 265 percent and 133 percent, respectively.

Saudi inclusion in Emerging Market indices is an indicator of growing investor's confidence in the Saudi market. It reflects the successful implementation of various capital market reforms, in line with the Financial Sector Development Program (FSDP) and Vision 2030. Saudi Arabia's inclusion in global equity and bond market indices will increase inflows into the equity market and increase demand for debt securities. Significant reforms have taken place in the domestic debt market including, the introduction of a primary dealer system and the extension of the government yield curve to maturities up to 30 yrs. Over time, these reforms will enhance the private debt market liquidity and provide savers with a broader range of instruments.

The country's inclusion in the global indices is expected to attract up to SAR 75 billion in passive inflows and billions in active inflows over the period of March 2019 to March 2020[(8)]. The Tadawul All Share Index (TASI) outperformed Emerging Markets (MXEF Index) significantly; as of March 2019, and ahead of the inclusion, in May 2019, a peak

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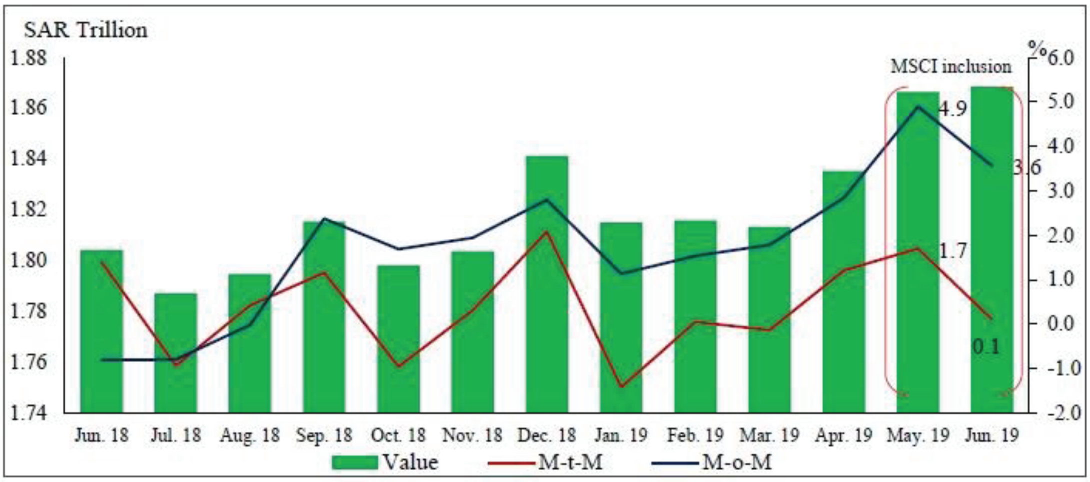
[7] Banks are required to maintain 20 percent of their total deposits in the form of high-quality liquid assets.
[8] According to the Saudi Capital Market's CEO press release and market analysts.

was reached. However, TASI stands relatively low in terms of Average Daily Value Traded (ADVT) in emerging markets compared to other emerging economies such as China and Korea, although it has the potential to continue to attract equity inflows[9]. Total ownership of "Foreign Investors" stood at 7.47 percent of total market capitalization as of 30 June 2019, an increase of 56 percent from the previous year[10].

Moreover, there has been a noticeable impact on liquidity after the inclusion as evidenced by an increase in the Broad Money Supply by 4.9 percent YoY as of June 2019. The inclusion influenced SAMA's foreign reserves positively as well. In addition, excess reserve approximated by the Net Reverse Repo of SAMA's standing facility showed a significant increase by 36 percent in June 2019 compared to the same period of 2018.

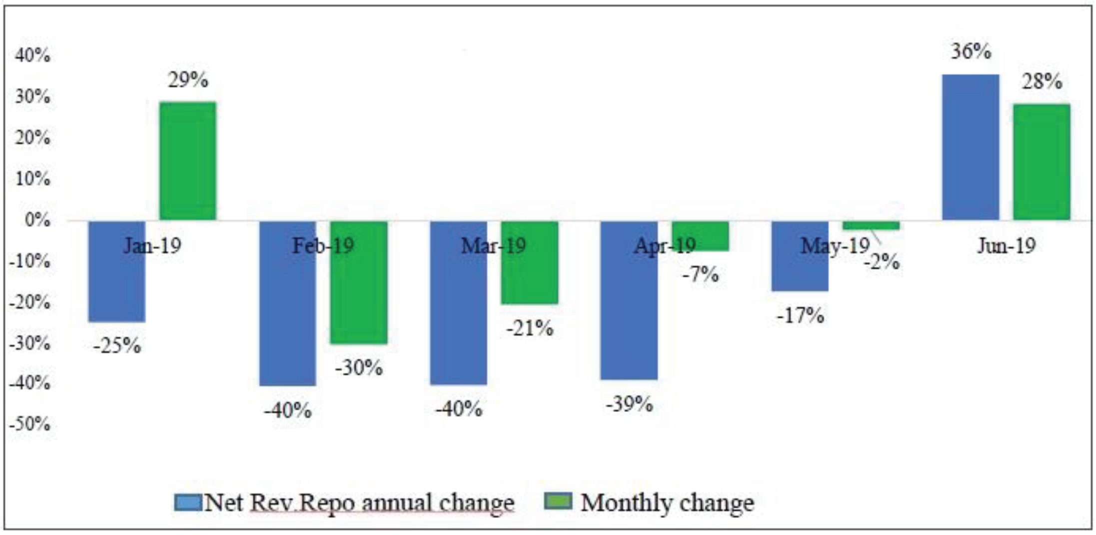
Chart (2): Money Supply (M3)



Source: Saudi Arabian Monetary Authority.

[9] Al Jazira Capital "TASI post MSCI inclusion report".
[10] Tadawul.

Chart (3): Net Reverse Repo



Source: Saudi Arabian Monetary Authority.

Central Bank Background Papers on Monetary Policy Frameworks in the Arab Countries

AMF - BIS Third Working Party Meeting on

Monetary Policy in the Arab Region

The Republic of Iraq

The Central Bank of Iraq

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13-14th November 2019

Monetary Policy Implementation in The Republic of Iraq

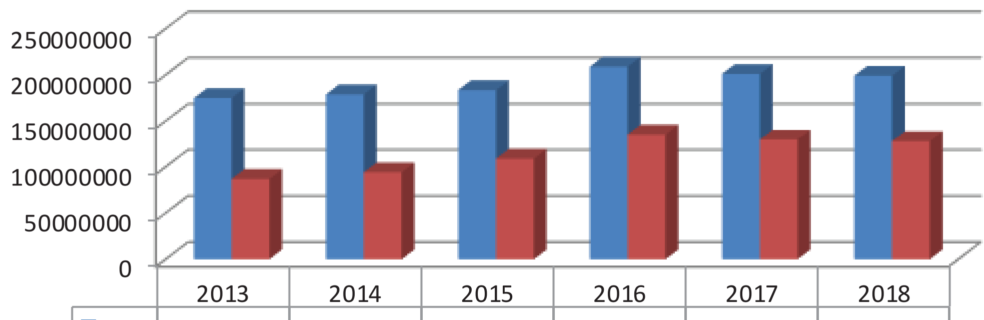
Monetary conditions were affected by the internal conditions that the country has witnessed since 2014, which impacted foreign reserves and triggered the Central Bank to undertake certain interventions to mitigate the negative effects of that conditions on monetary policy.

First: Monetary Policy Challenges

The Act of (CBI) (No. 56 of 2004) gives the Central Bank the full autonomy in managing monetary conditions to achieve price stability. However, the monetary policy in Iraq faces several challenges due to the economic conditions that prevailed since 2014.

One of the most critical challenges is the impact of economic structural imbalances. The oil sector contributed around 64.3 percent of the GDP in 2018, while the contribution of the agriculture and industrial sector reached 1.4 percent and 0.9 percent, respectively. This has led to an obvious imbalance in the structure of exports, where crude oil exports accounted for more than 99 percent of Iraq's exports for the last five years. Also, there is an imbalance in the structure of the public budget, where oil revenues accounted for 88.8 percent of the federal budget revenues for 2019.

Chart (1)
GDP at constant prices 2013-2018 (Million Dinars)
(in 2007 prices)



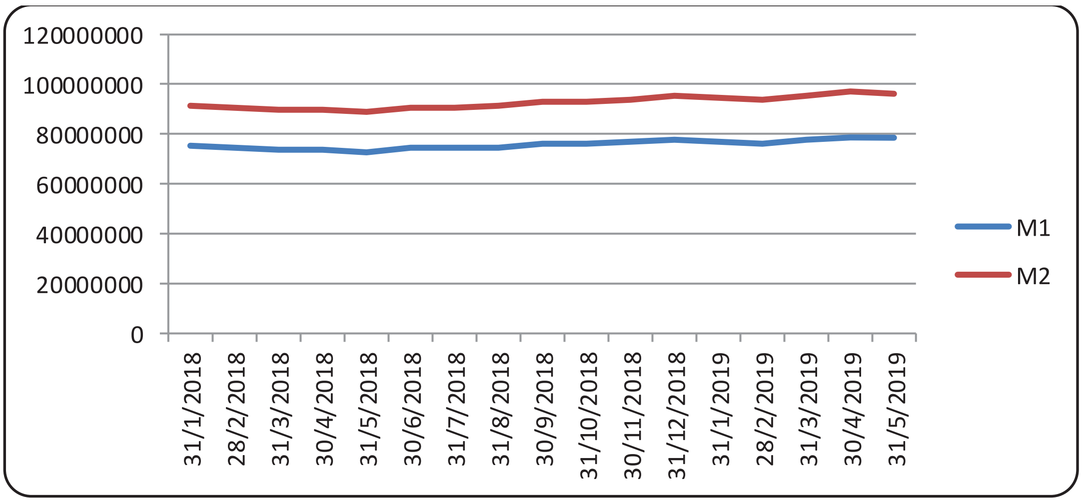
	2013	2014	2015	2016	2017	2018
GDP	174990175	178951407	183616252	208,932,10	201059363	199129299
Oil	86937214.7	94139560.1	108877465	135,393,33	129839551	128081507

Accordingly, the monetary policy in Iraq is facing severe challenges, which made it in front of a significant burden because of those imbalances. The first of those challenges is to coordinate with fiscal policy to target inflation, which led the (CBI) to seek independent monetary instruments that allow monetary policy to control inflation levels.

Also, the phenomenon of dealing with cash is another challenge facing monetary policy in Iraq. This is evident in the sizeable monetary mass that is circulated outside the banking sector. The percentage of cash circulated outside the banking sector reached 90.47 percent of the currency issued in January 2018, which rose to 90.6 percent in April 2019, hence weakening the monetary policy ability to manage liquidity and achieve monetary policy objectives.

During 2018 and the first half of 2019, the narrow money supply (M1) achieved a small growth rate reached 0.23 percent, while the broad money supply (M2) grew by 0.29 percent. Figure -2- Shows the growth of money supply during the period 2018-2019.

Chart (2)
Money supply (2018-2019)



The weakness of the banking system is also another challenge facing monetary policy because of the following:

- Limited banking products and services qualitatively and geographically and the engagement of banks in secondary or minor activities.
- The dominance of government banks over the banking sector as public banks account for more than 80 percent of the banking assets.

- High levels of non-performing debt and levels of concentration of credit facilities
- The weakness of institutional governance.
- The exposure to financial shocks resulted from the slowdown of the non-oil sector.

Second: Monetary Policy Achievements in Light of The Central Bank Strategy (2016-2020)

Despite the challenges mentioned above, the (CBI) has been exerting continuous efforts to ensure price and financial stability and smooth the functioning of the financial system. In this context, the (CBI) Strategy for the period (2016-2020) aims at:

1. Ensuring price stability

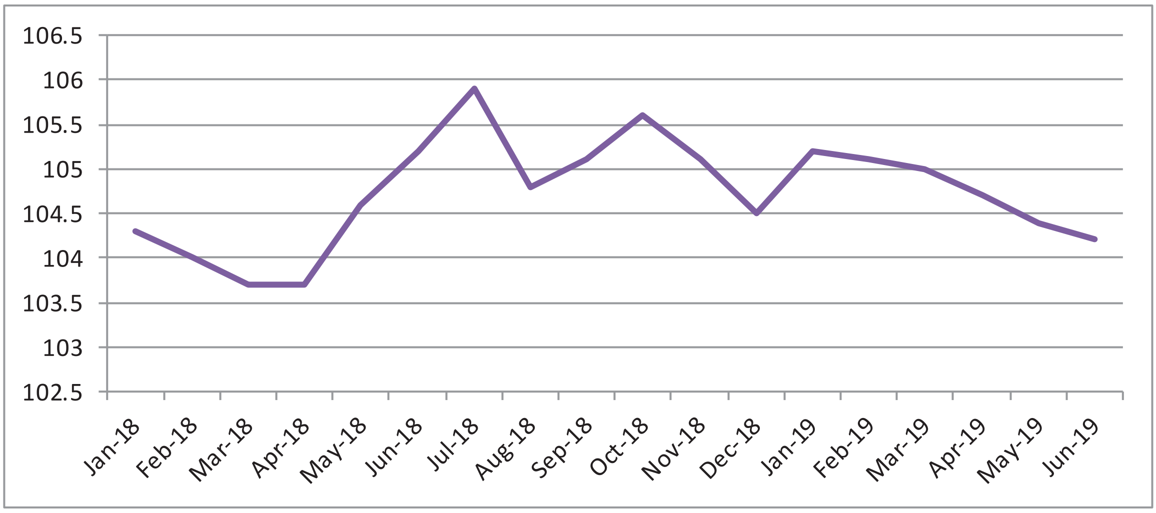
The stability of the exchange rate is one of the main priorities of the CBI monetary policy as it maintains appropriate stability in the general level of prices, thus, providing a suitable environment for investment. On this basis, the window of selling US Dollar plays an essential role in:

- Sterilizing cash surplus to contain inflationary pressures.
- Maintaining the stability of the exchange rate, considering that the (CBI) is the natural monopoly of foreign currency (Petro-dollar).
- Financing foreign trade, investor transfers and other purposes.

This window helped ensure the stability of Dinar against the Dollar at (1190 Dinar per Dollar). This was reflected in the relative stability of the market exchange rate during the period 1/6/2018 to 1/6/2019, with minor fluctuations not exceeding (-0.5 percent, +0.5 percent). The (CBI), through the currency window, has been able to:

- Reduce the gap between the official exchange rate and market rate from 62 points in January 2018 to 11 points in June 2019.
- Achieve significant stability in the general price level for period 1/1/2018 to 30/6/2019, with the fluctuations in the CPI during this period that didn't exceed 2 percent.

Chart (3)
Monthly Consumer Price Index (2018 – 2019)
(2012=100 percent)



2. Strengthening foreign reserves

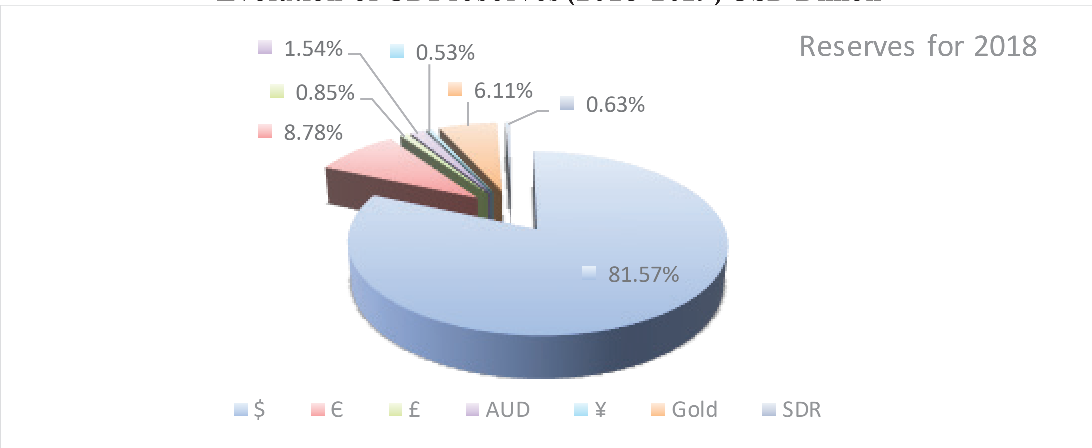
One of the main objectives in Central Bank portfolios risk management is to protect and stabilize Iraq's foreign reserves, diversify them, and ensure their liquidity. This preference comes within the frameworks of ensuring the effectiveness of monetary policy in addressing any possible shocks. The reserves can be utilized along the following lines:

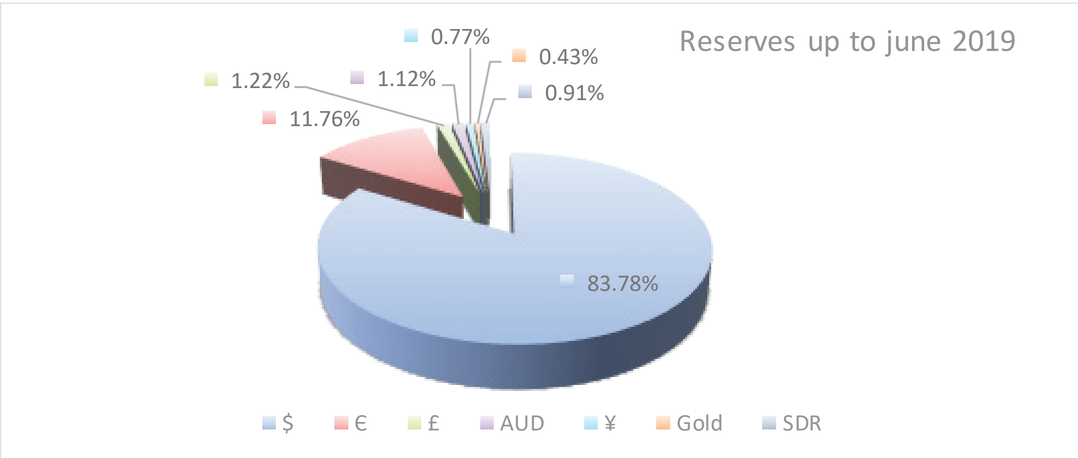
- Investing an important part of the reserves securely according to the principles of the revised investment guide that were agreed upon with IMF twelve- years ago. This considers as a part of portfolio diversification to gain appropriate returns including, US sovereign bonds with a high credit rating (AAA).
- Financing imports of goods, services, and various external transfers needed by the private sector.
- Intervention in the domestic exchange market to maintain the value of the Iraqi Dinar and defend the exchange rate regime.
- Controlling domestic liquidity levels and withdrawing excess cash flows that put pressure on domestic demand and its unwanted price results.

Iraq's foreign currency reserves have increased from USD 64.946 billion in 2018 to USD 67.484 billion in June 2019. Accordingly, Iraq is one of the Arab countries with the highest levels of foreign reserves. The foreign reserves cover 16 months of imports, and the reserve coverage ratio of money supply amounted to above 79.7 percent. This ratio is considered to be one of the highest rates, as maintaining a reserve ratio equivalent to (20 percent) of money supply in the broad sense is considered as an optimal ratio according to international standards for the adequacy of reserves in order to be able to support confidence in the value of the local currency in the event of any currency crisis, which is especially important for countries with emerging banking system. The policy of the (CBI) includes diversification in the constituent currencies of the reserve while giving greater weight to the US Dollar in the investment portfolio.

This is due, among other reasons, to the fact that the Dollar is considered the most stable currency in the world, to avoid risks in the management of reserves and to avoid unrealized gains (risks) resulting from fluctuations of other currencies against the Dollar. Moreover, this is part of the Bank's guidelines and in light of the (SBA), which includes the Iraqi government's commitment to Peg the Dinar to the Dollar.

Chart (4)
Evolution of CBI reserves (2018-2019) USD Billion





3. Shifting towards risk-based banking supervision

- Implementation of the International standards on banking supervision and application of Basel III requirements related to credit, operational, and market risks.
- Adoption of good governance and practical application of international standards to ensure financial stability and banking sector soundness through shifting to risk-based banking supervision.

4. Supporting and developing the Shariah-compliant banking industry:

Based on the importance of the Shariah-compliant banking industry, the (CBI) has sought within the framework of its plans to develop Islamic banking services and products in order to develop the capital market and activate non-interest based monetary policy instruments to contribute to social and economic development. The (CBI) has joined the Islamic Financial Services Board (IFSB) in Malaysia and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrain in a step that will help to develop Shariah-compliant banking sector in Iraq.

5. Enhancing financial inclusion

A National Strategy of Financial Inclusion has been adopted, and a Higher Committee for Financial Inclusion has been established within the framework of the technical assistance provided by the Arab Monetary Fund in October 2018. Iraq has made wide steps to achieve financial inclusion reflected in the increase of the proportion of individuals having bank accounts to reach 22 percent recently in 2017 compared to 11 percent in 2011.

Also, the Central Bank of Iraq is working on encouraging financial inclusion through licensing a number of electronic payment companies and seeking for the development of the electronic financial services. In this context, the national payment board has been established for the purpose of developing electronic payment and collection.

6. Establishment of Deposits Guarantee Institution

The CBI has supervised and licensed the Iraqi Company of Deposits Guarantee based on the regulation of deposits guarantee No. (3) of 2016 with a capital of 100 billion Dinar which was the contribution of all the banks operating in Iraq; public banks, national retirement authority/state employees retirement fund, and national insurance companies. The above step of the CBI came to achieve the following objectives:

- Protecting depositors' rights by providing a cover to ensure banking deposits.
- Enhancing confidence in the banking sector and ensure its soundness.
- Strengthening relations with international companies of deposits guarantee and exchanging of experiences and training.

The company withholds the lowest amount for deposits guarantee among the Arab countries, where it guarantees just one thousand Dinar for every 10000 Dinars. The company is subject to the CBI check, and its annual results and accounts are subject to the verification of the Federal Supreme Audit Bureau.

Third: The Developments of Monetary Policy Instruments

1. Interest Rate Policy

Due to the characteristics of the Iraqi banking system, the interest rate is not considered as a significant tool to be dependent upon in the monetary policy framework. The interest rates on saving deposits have been dropped from 4.06 percent in 2017 to 3.82 percent in 2018. the interest rates on fixed deposits have also fallen in varying proportions.

This has led to a decrease in interest rates on short-term loans from 12.57 percent in 2017 to 12.34 percent in 2018, while interest rates on medium-term loans decreased from 12.44 percent in 2012 to 12.19 percent in 2018. As for the interest rates on long – term loans, they have increased from 12.17 percent in 2017 to 13.18 percent in 2018, due to the high level of risk and uncertainty for such kind of loans in Iraq.

2. Development of Deposit and Credit Levels

Despite the decline in interest rate, the balance of deposits in various forms increased by 1.33 percent during 2018. The growth came as a result of the increase of current deposits by 1.5 percent, saving deposits by 0.96 percent, and fixed deposits by 0.74 percent. As for the cash credit, it achieved a low growth of 0.18 percent in 2018 due to the abundance of cash.

3. Deposit and Lending Facilities

The CBI maintained the monetary policy rate at 4 percent in 2019 as well as continued to work with investment windows for the 7, 14, and 30 days. However, the bank adjusted their associated interest rates as it increased the interest rate of 7 days investment facility to 1 percent instead of 0.5 percent, and the interest rate of 30 days investment facility to 1.5 percent instead of 1 percent. While the investment for (14) days was canceled as of 1/9/2018.

4. Deposit Facilities

Traditional certificates of deposit, or what is called the investment window, are an important outlet for the intervention of the Central Bank in liquidity management of the banking system. It worth mentioning that the deposit balances declined from ID 1058 billion in 2017 to ID 476 billion in 2018. The decrease came as a result of preventing public banks from investing in this monetary policy instrument.

5. Lending Facilities

The CBI has continued to use this tool to achieve the policy objectives of granting credit to banks in a manner that ensures control over banking sector liquidity and influences it through interest rates (price signals) set for each type as follows:

- Initial credit (6 percent) annually;
- Legal Credit (7 percent) annually;
- A loan of last resort (7.5 percent) annually.

6. Islamic Deposit Certificate

It is a Shariah-compliant liquidity management tool for Islamic banks. Also, it is considered an innovative type of Islamic Sukuk initiated in 2017 to manage short-term liquidity of Islamic banks. In January 2018, the CBI issued Islamic Deposit Certificates of medium-term (14 days) through the Central Securities Depository System (CSD) to diversify the investment portfolio of banks and manage the liquidity of the banking sector. The most important auctions held by the CBI in 2018 are:

- Ten auctions for a period of 14 days with an amount of issuance totaled 50 billion Dinars. The total actual amount was 126.6 billion, with an average price cut (0.7 percent), and the actual amount was paid in full.
- Five auctions for a period of 14 days with an amount of issuance 100 billion Dinars. The total actual amount was 69.3 billion Dinars, with an average price cut of 0.7 percent, and the actual amount was paid in full.
- The CBI stopped issuing Islamic deposit certificates of 14-days period as of September 2018 and, in turn, issued new certificates of 30, 91, 182, and 365 days.

7. The Required Reserve Ratio

In 2018, the CBI continued to adopt a proportion of 15 percent as reserve requirement on current deposit and 10 percent on saving and fixed deposits. At the end of 2018, the amount of required reserves on government deposits amounted to ID 6.9 trillion compared to ID 4.6 trillion in 2017 and ID 5.8 trillion in 2016. As for the deposits of the private sector, the amount of required reserve rose to ID 3.5 trillion compared with ID 1.9 trillion in 2017, which is equivalent to an increase of 83.2 percent.

8. Central Bank Remittances

In order to activate the indirect monetary policy instruments through open market operations and to achieve monetary stability, the CBI issued remittances of 182 and 365 days through the Central Securities Depository System as of September 2018. In this year, the CBI held the following auctions:

- Two auctions of (182 days) period for ID 100 billion per issuance, where the actual sold reached ID 140 billion at an average cut–off price of (2.5 percent), while the amount paid was ID 605.2 billion Dinars.
- Two auctions of (365 days) period for ID 100 billion per issuance at an average cut–off price of (2.9 percent), while there is no amount paid for that period.

Fourth: The CBI Initiatives in Financing Local Economy

The CBI has sought not only to use traditional monetary policy instruments (interest rate and exchange rate) to achieve its objectives and move towards non-traditional policy by financing economic projects. The CBI has allocated ID 6 trillion for this initiative to be fully implemented through the banking system in order to expand the domestic production base and stimulate the economy and provide employment.

The first part of the initiative targeted small projects with a financing amount of ID 1 trillion. By the end of 2018, a total amount of ID 65.8 billion has been extended through 31 banks, namely: 16 Islamic banks, 13 commercial banks, and two foreign banks to 2100 small projects that create at least 4200 job opportunities.

Table -1-
Small projects loans (2015-2018)

Year	Amount in Billion ID
2015	**6.0**
2016	**16.2**
2017	**18.6**
2018	**25.1**
Total	**65.8**

The second part of the initiative, amounting to 5 trillion Dinars, has been directed to the medium and large projects through specialized banks (industrial, agricultural, real estate, and housing fund). The share of these specialized banks in the amount of the Central Bank's initiative was as follows: industrial banks (33 percent), agricultural banks (33 percent), real estate banks (17 percent), and housing funds (17 percent). The CBI granted the initiative amount to the banks mentioned above at an interest rate of 2 percent and an allowance period of one and a half year. the interest imposed by these specialized banks on loans granted to beneficiaries are as follows:

- Industrial banks (2 percent),
- Agricultural banks (2 percent),
- Real estate banks (1 percent),
- while the housing fund does not impose any interest on the loans, it grants.

Conclusion

The Central Bank of Iraq Faced different economic and political challenges, either on the local, regional, or global level. In addressing these challenges. The Volume of these challenges enforced huge burdens and hard situations to be managed by the CBI. The monetary policy played a fundamental role in achieving sustainable growth, and it showed a very high degree of flexibility and capability to deal with these extraordinary events efficiently and successfully. Additional several updates of the monetary policy instruments, objectives, and switching toward non-traditional policy were adopted to achieves its goals.

Central Bank Background Papers on Monetary Policy Frameworks in the Arab Countries

AMF - BIS Third Working Party Meeting on

Monetary Policy in the Arab Region

The Sultanate of Oman

Central Bank of Oman

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13-14th November 2019

Monetary Policy Implementation in The Sultanate of Oman

Introduction

Like other GCC countries, the Omani business cycle is conditioned by oil prices as the hydrocarbon sector still contributes majorly to the economic activities directly and indirectly. However, oil prices are exogenous to the economy as international demand and supply conditions determine the course of their trajectory. In the last ten years, oil prices have witnessed large swings with touching the peak in early 2012 and plunging to a very low level in early 2016. Oil prices have since recovered considerably; however, they continued to be range-bound.

Omani economy, following the oil prices trajectory, remained in nominal contractionary mode during 2015 and 2016 before turning into positive territory in 2017 and 2018. Besides exogenous oil prices, the currency peg with the US dollar, and open capital account allows very little monetary policy independence as monetary conditions prevailing in the US are automatically transmitted to the domestic economy. At sometimes, the US monetary conditions (interest rate environment) don't move in sync with the Omani business cycle, which poses a serious policy challenge.

On the other hand, being a small open economy and a large dependence on imports, global developments also affect other activities, including inflationary conditions. Against the above backdrop, this paper attempts to analyze the implication of global developments on the monetary policy in Oman.

The scheme of the paper is as follows. Section II analyzes the current macroeconomic conditions in Oman. The transmission of the US monetary conditions to the Omani economy is empirically investigated in section III. Section IV analyzes the impact of global inflationary conditions on domestic inflation. The concluding observations are displayed in section V.

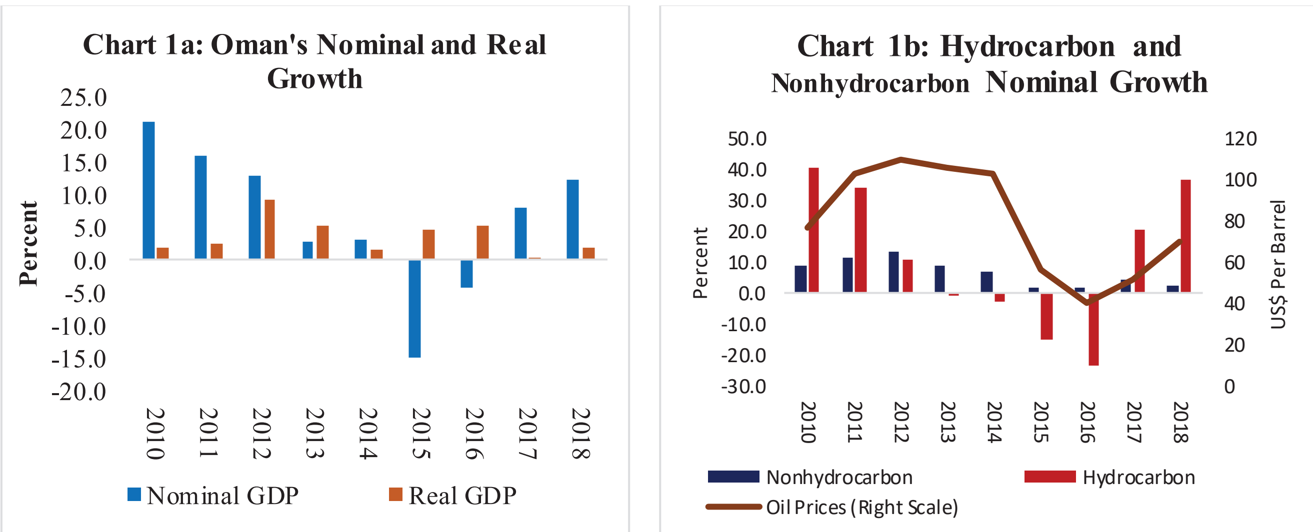
Current Macroeconomic Conditions

Omani economy recovered from the contractionary phase and grew in nominal terms by 7.8 percent in 2017 and 12.3 percent in 2018, and in real terms by 0.3 percent and 1.8 percent, respectively, during this period (Chart 1a). The nominal growth in the economy during the last two years was largely driven by the hydrocarbon sector, reflecting the surge in oil prices, whereas the non-hydrocarbon sector also contributed considerably to the real growth during this period on the back of tangible progress made by the diversification efforts.

As Oman has been pursuing diversification strategy with all seriousness to insulate the economy from vagaries of oil prices and generate employment opportunities in varied fields, the diversification in the economy is increasingly gaining traction. The Ninth and final 5-year Development Plan under Vision 2020 also continue to emphasize on more diversified economic activities to insulate the economy from external shocks.

Chart (1)

Oil Prices and Nominal GDP



Besides implementing dedicated strategy/ programs in the five identified sectors under “Tanfeedh” the government is pushing diversification through promoting public-private partnership (PPP), privatization, and improving the business environment. The government undertook some important policy measures during 2018, including:

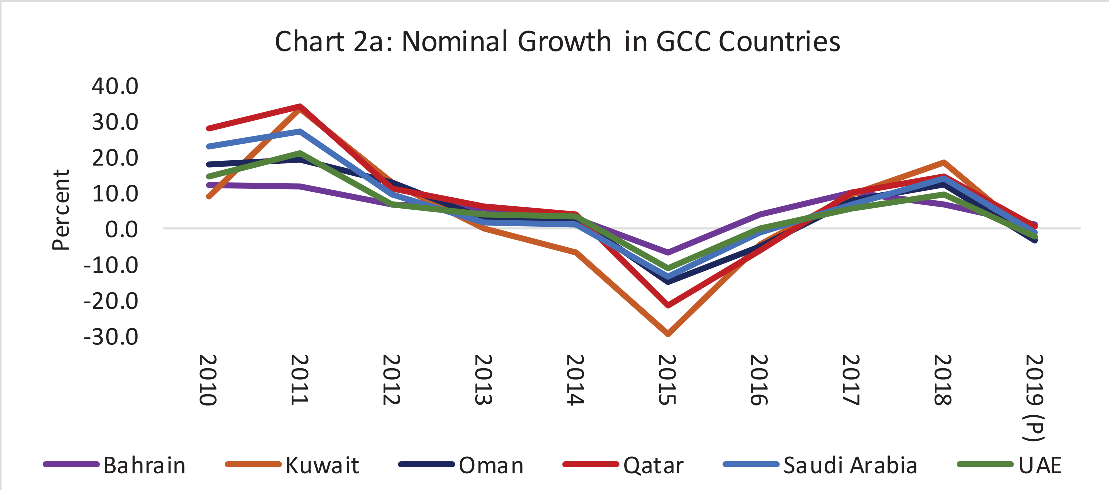
- The establishment of a commercial arbitration center,
- The adoption of new commercial companies' law,
- Further streamlining of licensing processes through "Invest Easy" to improve the business and investment climate and promote private sector-led growth in the Sultanate.
- The enactment of several important laws, as, Foreign Capital Investment, Privatization, Public Private Partnership, Bankruptcy law.
- The establishing the Public Authority for Privatization and Partnership in 2019 to give a much-needed impetus to the diversification and private-sector-led growth in the Sultanate.

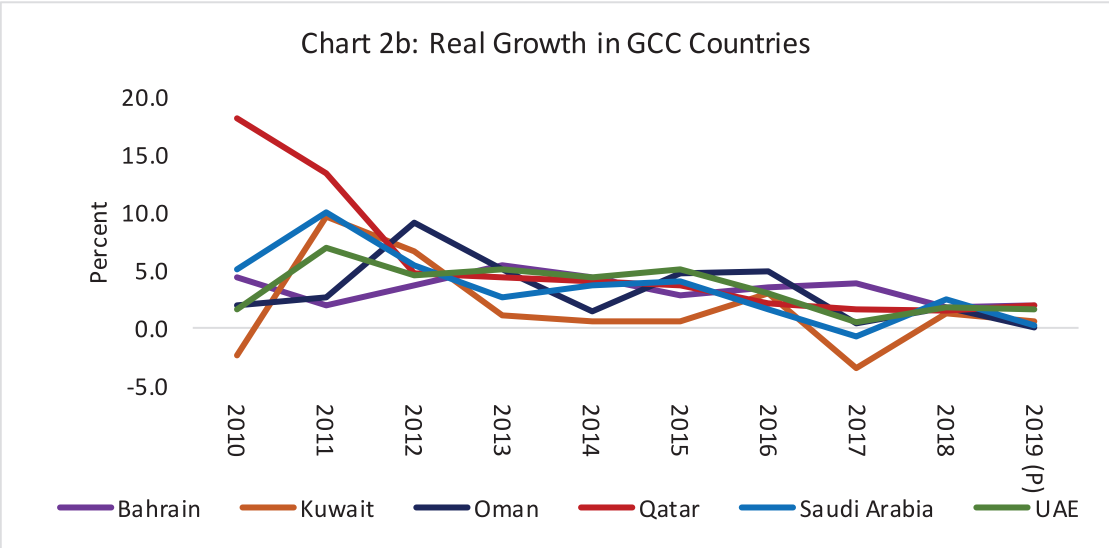
A cross-country analysis across the GCC region shows that all countries, witnessed good nominal growth during 2017 and 2018, while all countries also recorded positive real growth in 2018 despite production cut implemented under OPEC+ agreement. As per the latest projections by the International Monetary Fund (IMF), all the GCC countries would contract in nominal terms during 2019, reflecting range-bound oil prices (Chart 2a). However, most of the GCC countries are expected to witness positive real growth (Chart 2b).

The hydrocarbon sector remains the major source of the revenues and exports in Oman, with its contribution to government revenues and merchandise exports at about 78 percent and 65 percent, respectively, in 2018. Nonetheless, the oil prices dropping significantly during 2015 and 2016 and subsequently hovering at a lower level despite some recovery led to an enlarged deficit in both fiscal and current accounts (Chart 3).

Chart (2)

GDP in GCC Countries



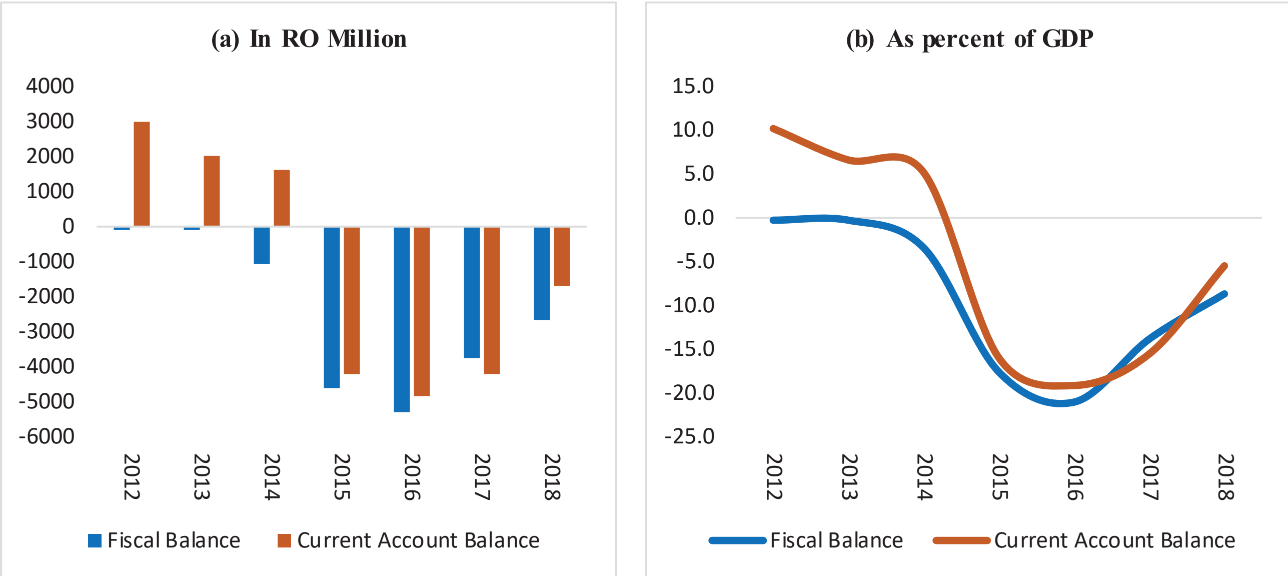


Source: IMF.

However, fiscal consolidation measures implemented by the government along with recovery in oil prices from the low level of 2016 resulted in some improvement as fiscal deficit and current account deficits as a percentage to GDP declined from 21.1 percent and 19.1 percent, respectively, in 2016 to 8.7 percent and 5.5 percent, respectively, during 2018. The twin-deficits hypothesis in macroeconomics suggests a causality from fiscal deficit to the current account deficit, which means that an increase in fiscal deficit leads to a rise in the current account deficit. It has also been empirically observed that the twin-deficits phenomenon holds true in the case of Oman also (CBO, FSR, 2018). Therefore, the fiscal consolidation, either through improving oil revenues or reduction in government expenditure, is also essential to restore external sector balance.

Chart (3)

Twin Deficits: Fiscal and Current Account



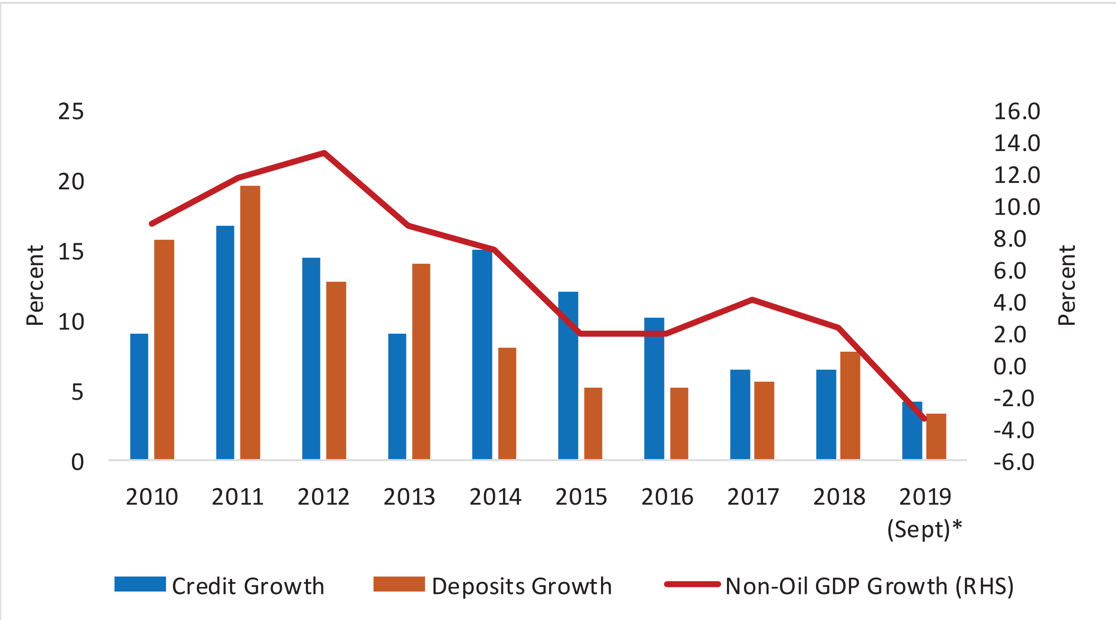
The enlarged fiscal deficit since 2015 has been financed mostly through external borrowings. Consequently, the government debt level increased substantially with its ratio to GDP inching up from 13.0 percent in 2015 to 47.5 percent in 2018. However, it continued to be within the prudent limit, and the market continues to exude confidence, as Government has been able to raise the debt from the market successfully at the market-linked interest rate. The government also raises a part of its debt through domestic borrowings by issuing the government development bonds (GDBs) and the government Sukuk with an additional objective of developing the domestic fixed income market, which would improve the monetary policy transmission in the Sultanate.

The authorities in Oman are making continuous efforts to reduce the twin deficits, and several measures, including the reduction in energy subsidies, hiking other government user fees, increasing the corporate tax rate, rationalization of government expenditure, etc. The expected implementation of the value-added tax (VAT) in the near future would boost the non-oil revenue of the government and help to insulate the fiscal conditions from the vagaries of oil prices. The VAT would also pave the way for other tax reforms, including the implementation of income tax at the later stage.

An inter-ministerial committee (Tawazun) has been set up recently to work out a plan and recommend measures/roadmap to reduce the fiscal deficit on a sustainable basis. Furthermore, persistence progress in non-oil economic activities and private sector-led growth would also help in reducing twin deficits and promoting sustainable macroeconomic stability in the Sultanate.

Notwithstanding persisting macroeconomic imbalance, the banking sector has been displaying resilience and meeting the credit needs of all segments. Nonetheless, the uncertainty surrounding the economic environment on the back of volatile oil prices impinged the growth in the banking sector in Oman (Chart 4). The increase in banking credit decelerated from 11.2 percent in 2015 to 6.4 percent each in 2017 and 2018, respectively, and further to 4.2 percent during Jan-Sept 2019. The growth in bank deposits declined from 8.0 percent in 2015 to 5.6 percent in 2017 but increased to 7.8 percent in 2018 before falling to 3.3 percent during Jan-Sept 2019.

Chart (4)
Credit and Deposits Growth in Oman



*Data on growth in non-oil GDP for 2019 pertains to June.

The banking sector in Oman has maintained a high capital adequacy ratio at 17.9 percent at the end of June 2019, much higher than the required at 13.5 percent. The credit risk remained predominant in banks in Oman with Credit Risk-Weighted Assets (CRWA) accounting for over 90 percent of the total risk-weighted assets (Financial Stability Report, CBO, 2018). Furthermore, banks have been maintaining a good quality of assets, albeit the delinquency rate [1] went up marginally from 2.8 percent in December 2018 to 3.0 percent during June 2019. The Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) in December 2018 stood at 253.6 percent and 114.6 percent, respectively, well above the regulatory requirements of 90 percent and 100 percent, respectively, indicating sufficient liquidity buffers

Global Developments and Monetary Policy in Oman

Oman is a small open economy that still relies considerably on the hydrocarbon sector, and hence, global developments affect the economy significantly, including the monetary conditions. Furthermore, Oman has a fixed exchange rate (Rial Omani is pegged to USD), which does not provide much monetary policy independence (impossible trinity or macroeconomic trilemma problem). Against the above backdrop, the Central Bank of Oman (CBO's) protects the pegged exchange rate to attain the other intended macroeconomic objectives, such as economic growth, stable inflation, and financial stability.

Consequently, the US monetary conditions are transmitted automatically to Oman largely, reflecting nearly free arbitrage between the assets of two countries. While protecting the currency peg, the CBO's monetary policy implementation mainly consists of setting the policy rate and interest rate on other standing facilities in line with the US Fed Rate and ensuring adequate liquidity (both domestic currency and US dollar) in the system. Oman's policy rate (Repo Rate) is linked to the US Fed Fund Rate through LIBOR as it is defined as USD Libor plus 50 basis points, or 1 percent, whichever is higher. Interest rates on other standing facilities offered by the CBO are also linked to

LIBOR. The prudential regulations and controls, however, allow some space to the CBO for monetary policy implementation.

An empirical exercise has been undertaken to ascertain the transmission of USA monetary conditions to Omani economy. Since both USA's effective federal fund rate (EFFR) and Oman's overnight inter-bank rate (OIR) are stationary in first difference, the Cointegration model (propounded by Johansen 1988; Johansen and Julies, 1990 and known as VECM) is estimated to empirically investigate the impact of EFFR on Oman Interest Rate (OIR), using monthly data from January 2008 to August 2019.

Autoregressive Distributed Lags (ARDL) model is also used to corroborate the results of Johansen's VECM. The long-run cointegrating equation has been normalized on OIR [2]. The results of the Cointegration model, furnished in the table below, corroborate the robust transmission of USA monetary conditions to Omani economic, as it is found that the US's EFFR impacts the Oman's OIR rate is statistically significant.

The error correction mechanism (ECM) is found to be statistically working, meaning thereby that any deviation of OIR from the long-run equilibrium path, suggested by EFFR trajectory, is automatically corrected over the next few periods. The results of the empirical model are also consistent with Raisi, Al Amal, et al. (2019), who conclude that the USA EFFR is the main driver of Oman's OIR.

Table: Long-run Cointegrating Equation (Sample: Jan 2008 to Aug 2019)				
Variable	**Johansen's VECM**		**ARDL**	
	Coefficient	t-stat	Coefficient	t-stat
EFFR	1.148***	23.89	1.120***	26.81
C	-0.152		-0.033	
ECM	-0.273***	-9.843	-0.365***	-10.091
***, **, and * denote 99 percent, 95 percent, and 90 percent level of significance, respectively.				

Chart 5: Response of OIR to EFFR Innovation using Cholesky (d.f. adjusted) Factors

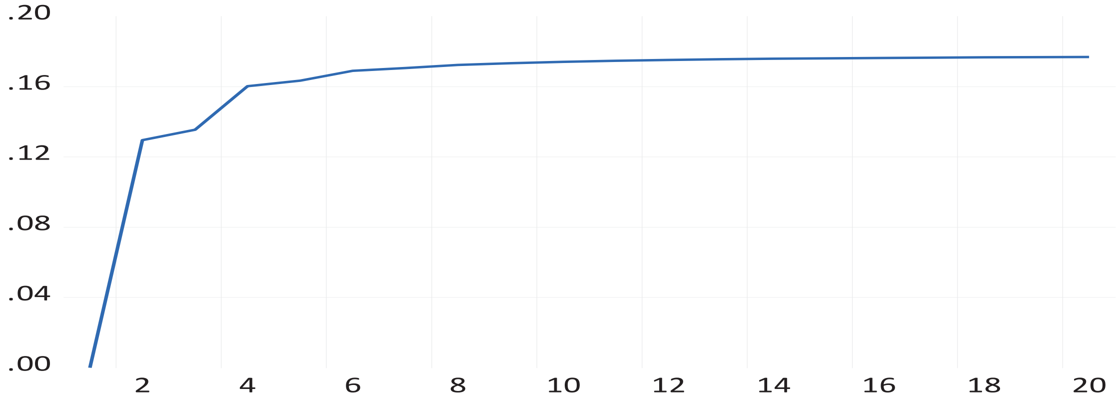
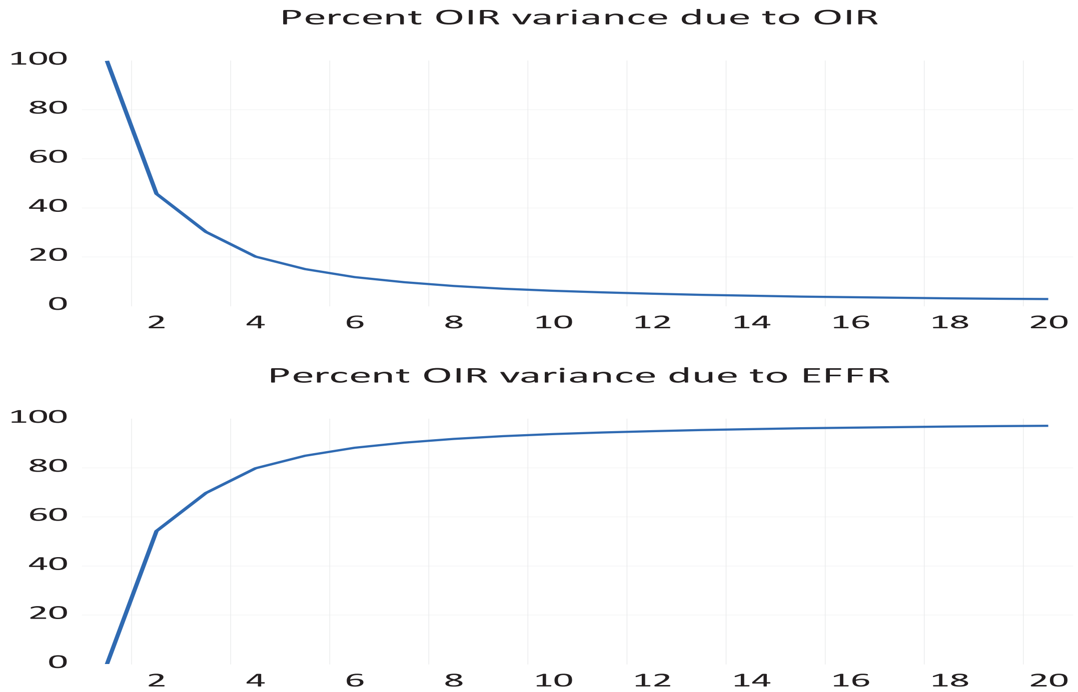


Chart 6: Variance Decomposition using Cholesky (d.f. adjusted) Factors



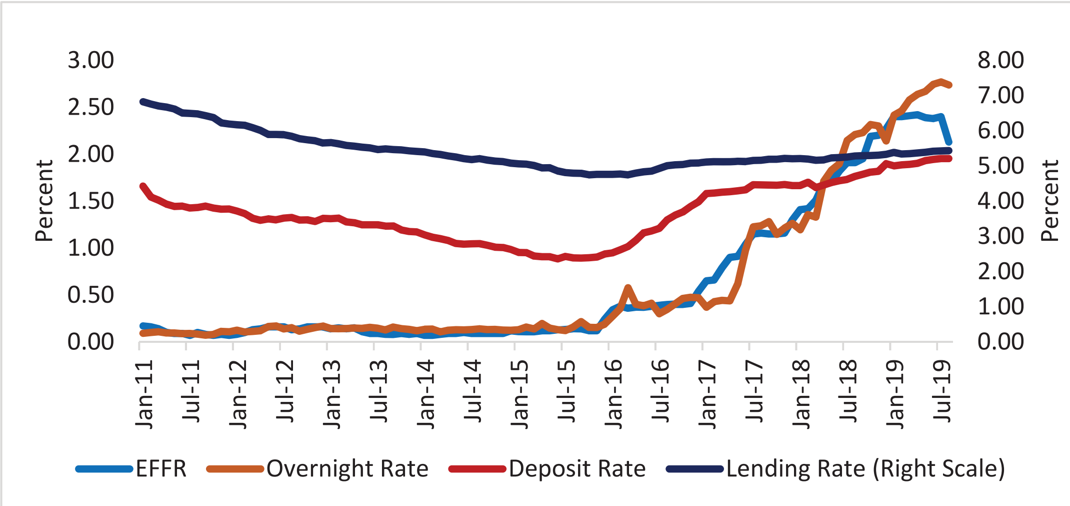
The above reported empirical results amply demonstrate that global developments, especially USA monetary conditions, considerably affect the domestic monetary conditions in Oman. Accordingly, the onset of monetary policy normalization in December 2015 by the Federal Reserve led to an increase in domestic interest rates across the spectrum in Oman (Chart 7). The Fed raised the policy target rate successively by a cumulative 225 basis points until December 2018.

In view of the evolving macroeconomic conditions, the Fed, however, paused the normalization process and started cutting interest rates in July 2019, reducing so far by a cumulative 50 basis points. Currently, the target for Fed Fund Rate stands at 1.50-1.75 percent. Oman's weighted average OIR increased from 0.19 percent in December 2015 to 2.14 percent in December 2018 and further to 2.77 percent in July 2019 before declining marginally to 2.74 percent in August 2019.

The weighted interest rate on local currency deposits and lending increased by 102 basis points and 67 basis points, respectively, during the period December 2015 to August 2019. Although domestic interest rates remain largely aligned to those prevailing in the USA, they tend to vary somewhat from those in the USA intermittently.

Espinoza and Prasad (2012) also find some deviation of domestic interest rates in Oman from US FED policy rate empirically. Some divergence is expected between interest rates prevailing in Oman and USA because of risk premia, transaction costs, and less than perfect arbitrage, but the evolving domestic liquidity conditions and prudential limits and controls may also contribute to such deviation.

Chart (7)
Domestic Interest Rates and Effective Federal Fund Rate (EFFR)

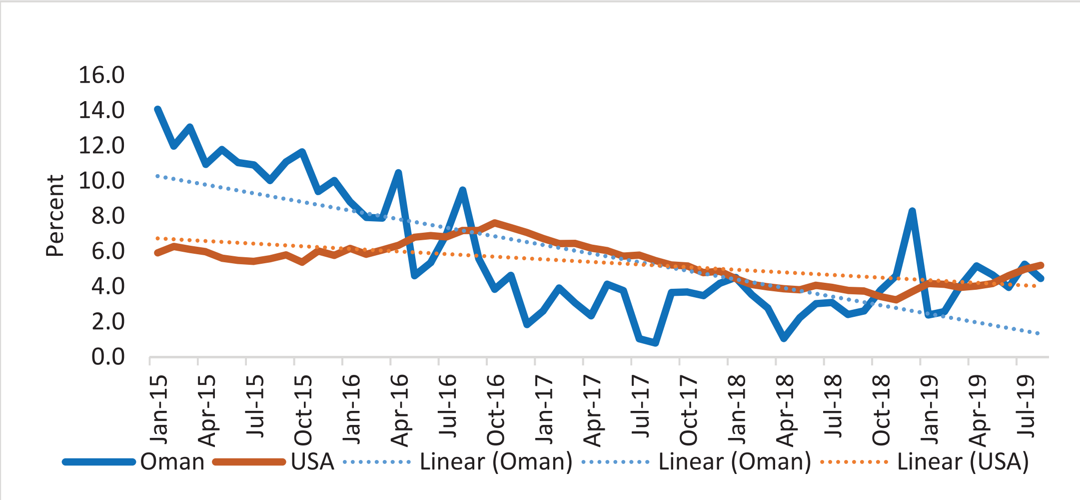


The increase in domestic interest rates, following the normalization of monetary policy in the USA, helped the currency peg by incentivizing capital inflows and discouraging capital outflows. However, the upward movement in interest rates was not in sync with the domestic business cycle that has been going through a subdued and uncertain phase.

The money supply growth, another indicator of monetary conditions, also decelerated significantly in Oman over the last three years, suggesting some tightening (Chart 8). The money supply growth in the USA also decelerated during this period but at a slower pace.

The year-on-year (YoY) growth in Oman's broad money declined sharply from 10 percent in December 2015 to 4 percent in July 2019, while the YoY growth in the USA's broad money decelerated from 5.8 percent to 4.6 percent during this period. Besides the transmission of monetary conditions prevailing in the USA, the range-bound oil prices and an environment of uncertainty appears to have driven deceleration in the growth of money supply in Oman.

Chart (8)
Money Supply Growth (Year-on-Year)

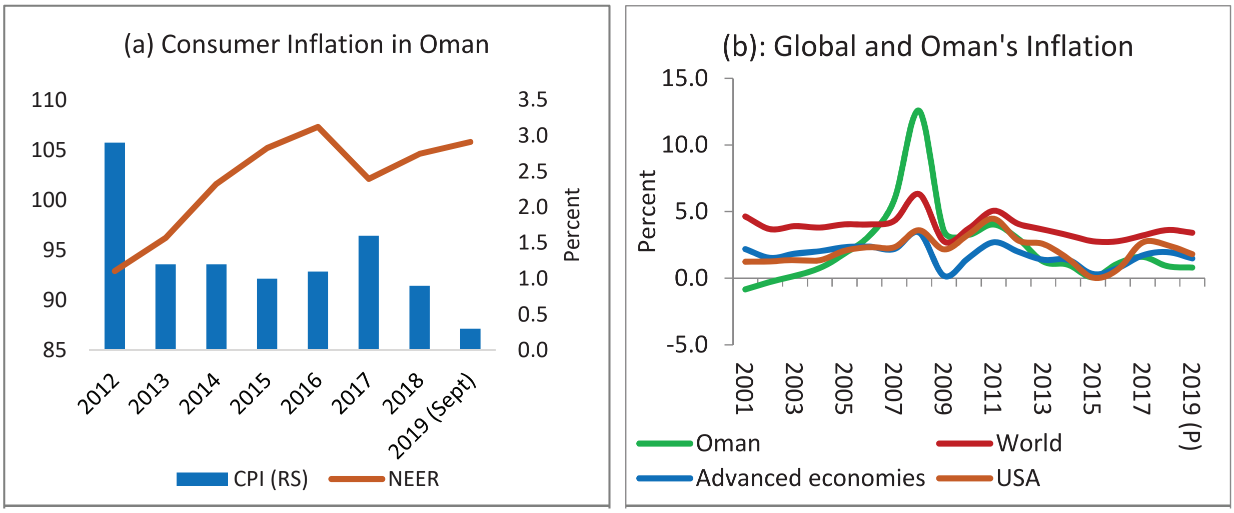


Transmission of Global Inflationary Conditions to Oman

Inflationary conditions in Oman, like many GCC countries, are primarily conditioned by imported inflation due to the nature of the economy, i.e., small open economy with a currency peg, open capital account, and large dependence on imports for consumption and investment.

The domestic factors, however, play some role in shaping the course of inflation at times. Inflation in Oman dropped from 1.6 percent in 2017 to 0.9 percent in 2018 and further to 0.3 percent in the first nine months of 2019 (Chart 9a). The global factors, along with muted domestic demand, led to benign inflation in the Sultanate. It could be seen that Oman's inflation has been mainly moving in tandem with global inflation, particularly with inflation in advanced economies, over the years (Chart 9b).

Chart (9)
Inflation Environment



Source: IMF Database.

The correlation coefficient between consumer inflation in Oman and that in advanced economies and the USA stood at 0.53 and 0.63, respectively, during 2001-2018, suggesting strong association. Global developments, such as a subdued increase in non-fuel international commodity prices, appreciation in the US dollar, and transmission of USA monetary conditions remained instrumental behind benign inflationary conditions in the Sultanate. Besides global factors, the subdued domestic demand, conditioned mainly by ongoing uncertainty due to range-bound and volatile oil prices and increased interest rates, also contributed to the disinflation process in Oman in the recent past.

Concluding Observations

Oil exporting economies, including Oman, have been witnessing uncertain economic environment largely due to range-bound and volatile oil prices on the back of global developments. The monetary conditions prevailing in the USA are automatically transmitted to the Omani economy due to its currency peg arrangement with the US dollar and open capital account. The empirical results of the Cointegration model also corroborate such transmission, as the US's EFFR is found to be the driver of Oman's overnight interbank rate.

Accordingly, the monetary policy normalization in the USA, pursued from December 2015 to December 2018, led to the tightening of monetary conditions in Oman as domestic interest rates increased considerably over the last three years. The tightening of monetary conditions, however, was not in accord with the business cycle and, in fact, affected consumption and investment, exacerbating economic uncertainty in the country. Despite monetary conditions moving opposite to the domestic business cycle, the CBO has little scope to react due to the lack of monetary policy independence.

On the other hand, as imported inflation is the main driver of inflation in the Sultanate, global developments resulted in benign inflationary pressures during the last few years. Global developments, such as subdued increase in non-fuel international commodity prices, appreciation in US dollar, and transmission of USA monetary conditions remained instrumental behind benign inflationary conditions in the Sultanate.

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Appendix Table 1: Lags Selection for VECM

Endogenous variables : OIR EFFR

Sample: 2008M01 2019M08

Lag	LogL	AIC	SC	HQ
0	-46.15515	0.752424	0.796987	0.770530
1	373.3324	-5.739569	-5.605880*	-5.685250*
2	374.7277	-5.698871	-5.476056	-5.608340
3	378.2180	-5.690906	-5.378965	-5.564163
4	388.7637	-5.793183	-5.392116	-5.630227
5	391.3038	-5.770372	-5.280179	-5.571204
6	395.2767	-5.769948	-5.190629	-5.534568
7	398.5569	-5.758701	-5.090257	-5.487109
8	406.5826	-5.821602	-5.064032	-5.513798
9	408.0463	-5.781974	-4.935277	-5.437957
10	414.3040	-5.817250	-4.881428	-5.437021
11	424.1415	-5.908461	-4.883512	-5.492019
12	430.1830	-5.940359*	-4.826285	-5.487705

*Indicates lag order selected by the criteria.

AIC: Akaike information criteria.
SC: Schwarz information criteria.
HQ: Hannan-Quinn information criteria

Appendix Table 2: Johansen Cointegration Test Summary
Selected (0.05 level*) Number of Cointegrating Relations by Model

Data Trend:	None	None	Linear	Linear	Quadratic
Test Type	No Intercept No Trend	Intercept No Trend	Intercept No Trend	Intercept Trend	Intercept Trend
Trace	1	1	1	2	2
Max-Eig	1	1	1	2	2

*Critical values based on MacKinnon-Haug-Michelis (1999)

Appendix Table 3: ARDL Bound Tests
Null Hypothesis: No levels relationship

Test Statistic	Value	Signif.	I(0)	I(1)
			Asymptotic: n=1000	
F-statistic	33.42225	10percent	3.02	3.51
K	1	5percent	3.62	4.16
		2.5percent	4.18	4.79
		1percent	4.94	5.58
			Finite Sample:	
Actual Sample Size	136		n=80	
		10percent	3.113	3.61
		5percent	3.74	4.303
		1percent	5.157	5.917

Central Bank Background Papers on Monetary Policy Frameworks in the Arab Countries

AMF - BIS Third Working Party Meeting on

Monetary Policy in the Arab Region

The State of Palestine

The Palestine Monetary Authority

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13-14th November 2019

Monetary Policy Implementation in The State of Palestine

Background

The Palestinian economy is a small and open economy [11] with limited resources and industrial base. Given the rise of uncertainty, internally and externally, the economy became more vulnerable to many shocks, external as well as internal ones, in particular, to the monetary and non-monetary forces, fluctuations in oil and food prices, and to irregularity and declining of foreign grants.

Palestinian economy operates in a high-risk environment, including monetary forces or policy decisions that are taken in the United States of America and Jordan, as well as in Israel since Palestine uses the currencies of these countries in the absence of national currency. Also, the Palestinian economy is impacted by a range of non-monetary factors, such as; restrictions and closures that have been placed over the years on the Palestinian trade and on access and movements of Palestinian employment in Israel. It is also impacted by the growth level of the Israeli economy (as the main trading partner), and the fluctuations and decline of foreign grants and support.

Recent global and regional developments

The pace of recovery in 2018 slowed rapidly amid tight monetary policy in a number of major economies and the increasing uncertainty of the future of economic and trade relations. The majority of advanced countries experienced a marked change in growth trend (excluding the United States), with the group's growth rate as a whole slowing from 2.4 percent in 2017 to 2.2 percent in 2018. The Eurozone's response to the suspension of the asset-purchasing program and the trade tensions that prevailed during the year had a major impact on its economies, which experienced the greatest slowdown within the group. Japan

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[11] It is open for 4.8 million Palestinians living in West Bank and Gaza Strip, in an area of 6,220 km^2, of which 5,860 km^2 in the West Bank, and 360 km^2 in Gaza Strip.

also quickly slowed down affected by natural disasters during the year, and export sensitivity to China's slowing performance. The slowdown came despite the magnitude of quantitative easing packages and the commitment of financial and monetary authorities to provide the entire stimulus needed to support economic growth.

The slowdown extended to emerging countries, which grew up by 4.5 percent in 2018 compared to 4.8 percent in 2017, due to weak global demand and to the U.S. protectionist measures. China is at the forefront of these countries after the glow of its economic growth, which is burdened by weak export amid trade protectionism, and alarming levels of public and private indebtedness. It Followed by India, which has struggled to maintain relatively high growth rates, despite being preoccupied with a number of reforms in its tax system (imposing goods and services tax) and its investment environment (facilitating the entry of foreign investors into the market). Brazil's growth rates have stabilized at low levels for an economy recovering from a severe crisis.

Despite the economic slowdown in advanced countries, unemployment in these countries has declined, inflation has accelerated to their target levels, and wage levels have risen, indicating that many of these economies are approaching full employment levels (the United States, Japan, and Germany).

In emerging countries, labor market conditions varied according to their respective conditions, with many moving towards higher unemployment rates. All of them were involved in facing higher inflationary pressures, as crude oil and basic food commodities prices surged in 2018.

As inflation approaches its target levels, some major economies have continued to tighten their monetary policies. The Fed raised the U.S. dollar rate four times in 2018. The European Central Bank gradually lowered the cap on its asset purchase program until it was completely suspended in December. Several other countries, notably Japan, have maintained their easing policies unchanged, pending a higher price response to stimulus efforts, or fear of an early withdrawal in the face of relatively weak economic growth.

At the regional level, the Israeli economic growth during 2018 has slowdown to 3.3 percent, compared to 3.5 percent a year earlier. At the same time, unemployment continued to decline to 4.0 percent, compared to 4.2 percent in 2017, as well as a continued rise in wages. Concurrently, inflation has begun to accelerate, reaching 0.8 percent, compared to 0.3 percent in 2017. Despite this acceleration, inflation levels are still below what has been seen in many advanced countries that have reached (or are close to) their target levels. This may be due to limited monetary stimulus procedures, only limited to a relatively low-interest rate, which the Bank of Israel tended to raise at the end of the year by only 0.15 percentage points to 0.25 percent.

On the other hand, the growth of the Jordanian economy has slowed again in 2018 to 1.9 percent compared to 2.0 percent in the previous year, while unemployment continued to rise to 18.6 percent from 18.3 percent the previous year. Despite the economic slowdown, inflationary pressures have increased, rising to 4.5 percent from 3.3 percent in 2017, mainly due a series of price adjustments and tax reforms aimed at controlling the budget deficit, including raising taxes on certain consumer goods, such as cigarettes, imported cars, and reducing government subsidies on bread. In this context, interest rates have seen several increases during the year, mostly in line with those of the U.S. dollar (anchor currency). Central Bank of Jordan increasing its main policy rate by 0.25 percentage points three times during the year to settle at 4.75 percent at the end of 2018.

At the local level and despite the peculiarity of the Palestinian economy, its growth trend during 2018 was consistent with those observed in the global and regional environment in general. The slowdown in the Palestinian economy continued during 2018, affecting the West Bank, while Gaza Strip has witnessed a significant downturn. The growth rate was about 0.9 percent in 2018 compared to 3.1 percent the previous year, affecting by the decline in the growth in the West Bank to 3.1 percent, compared to 8.5 percent the previous year, and the continued deterioration in Gazan economic activities by 6.9 percent compared to a downturn of about 12.5 percent in 2017.

The disparity in performance between the West Bank and Gaza reflected in a similar variation in inflation trends. On the one hand, price levels in the West Bank achieved marginal growth of only 0.4 percent compared to price stability in 2017, while prices in Gaza shrank by 1.3 percent compared with limited growth of 0.1 percent in 2017. As a result, prices in Palestine fell by 0.2 percent in 2018.

In addition, unemployment largely reflected the different economic conditions between the West Bank and Gaza. It fell from 18.7 percent to 17.6 percent in the West Bank, while in Gaza, it rose from 44.4 percent to 52.1 percent. Gaza Strip had the greatest impact on the overall unemployment rate in Palestine, which rose from 28.4 percent in 2017 to 30.8 percent in 2018.

Monetary policy Objectives

The Palestine Monetary Authority (PMA)'s Law No. (2) for 1997, set the main objectives of the monetary policy as to ensure the safety of the banking sector, maintain monetary stability, and encourage economic growth in Palestine in accordance with the general policy of the government.

A new draft law for Palestine Central Bank was recently submitted for approval. The draft law aims to strengthen the independence of the Central Bank and to assure and enforce its rule in maintaining monetary and financial stability. It contains more detail and clarity in the functions of the Central Bank, which includes:

1. Maintaining monetary stability by preserving price stability;
2. Maintaining financial stability;
3. Contributing to support the Government's public economic policies in order to achieve the desired economic goals;

Monetary policy framework and its efficiency

PMA was established to serve a broad range of central banking functions as envisaged in Paris Protocol. However, the absence of the national currency [(12)], prevents the formulation and implementation of a comprehensive monetary policy. This means that PMA has no control over the domestic money supply and little influence on domestic interest rates, exchange rates, inflation, and asset prices.

In line with PMA's main objective to secure the stability of the banking and monetary system, it does not refinance banks or act as lender of last resort but provides liquidity support to banks in certain cases and upon the banks request. Also, because of the lack of a domestic money market, domestic government securities [(13)], and a yield curve, it does not conduct open market operations.

Thus, the PMA's monetary policy framework is still limited, with limited available policy tools, which mainly used for prudential purposes. However, the PMA can influence the economy through its prudential regulations and related policy tools such as (i) reserve requirements, and (ii) placement of reserves at commercial banks to support liquidity.

Therefore, the credit channel is the main transmission channel of monetary policy. It can influence the credit supply to the private sector by altering the incentives for bank lending and the composition of banks' loan portfolios.

Recent developments and its implications on monetary policy

The implementation of monetary policy in Palestine is affected by certain regional developments. On the one hand, as a consequence of its coerced

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12 Instead, four main foreign currencies circulated in the Palestinian market: the US dollar-USD, the Jordanian dinar-JD, the New Israeli shekel-ILS, and to a lesser extent, the Euro.

(13) The development of a domestic securities market would expand the financing options. Domestic financing options are currently very limited, as government debt is not securitized and not held by the general public, so establishing a market for securitized government debt would help deepen the financial market, and over time, provide the Government with more flexible and modern financing options.

dependence on its Israeli economic counterpart, the Palestinian economy is influenced by the Israeli monetary policy and the degree of steadiness of the Israeli shekel as a currency of trade and a major constituent of Palestinian banks' assets. Also, the Palestinian's financial system is indirectly affected by price fluctuations, demand for Palestinian workers in the Israeli market, restrictions to Palestinian trade, and the inconsistent transfers of tax proceeds (clearance revenues) to the Palestinian side.

On the other hand, the Jordanian economy is the second most influential economy affecting economic and financial stability in Palestine, owing to the close ties and interconnectedness of the two economies, especially between their banking sectors. By the end of March 2019, Jordanian banks assets account for 42.3 percent of the total assets of the Palestinian-banking sector; 37.4 percent of the total credit granted in the Palestinian market; and about 43.2 percent of total customer deposits. The Jordanian dinar accounted for 22.9 percent of the total deposits in the Palestinian-banking sector and 15.2 percent of the total credit portfolio. These ratios reflect that the stability of the Jordanian financial and monetary systems is crucially vital to the Palestinian economy.

At the local level, the fiscal performance of the Palestinian government, directly and indirectly, affects the stability of the banking sector, which constitutes the most critical component of the financial system. Likewise, Jordan's (and Israel's) economic growth is regarded as the most prominent variable influencing credit granting by Palestinian banks, alongside variations in the interest rate on the currencies circulated in the Palestinian market (U.S. Dollar, Jordanian Dinar, and Israeli Shekel).

Monetary Policy Implementation: Main Challenges and Reforms

The implementation of monetary policy in Palestine faces several challenges, most prominent are as follows:

- Absence of a Palestinian currency.

- The Fragile relationship between banks operating in Palestine and correspondent banks in Israel.
- Incomplete legislative structure, which hinders the passage of laws, compounded by the absence of specialized financial courts.
- Lack of control over borders and crossings and the associated obstacles to freedom of movement and access, and lack of control over large areas of the West Bank (Area C).

Even though it does not conduct a comprehensive monetary policy in common sense, due to the absence of a national currency, PMA made relentless effort to enhance capabilities and put in place the requirements for formulating and conducting monetary policy in the future. This includes:

- Developing instruments for economic and financial monitoring and analysis;
- Preparing studies and periodic reports like the Annual Report, the Financial Stability Report, the Inflation Report, and the Quarterly Economic Report.
- Transforming the backward-looking approach of reporting to a forward-analysis, to allow better tracking and forecasting of economic growth and inflation trends and macroeconomic disturbances. Such methodology helps PMA to provide private and public sector decision makers with informed advice on inflation developments, outlooks and risks, thus fulfilling its duty as an economic and financial advisor to the government.
- Simultaneously, the PMA employed accessible monetary policy tools, particularly the required reserve ratio. The PMA also commenced preparations for engaging in open market operations.
- PMA is also tasked with the management and investment of its foreign reserves, in a manner which gives priority to safety and liquidity over undue profits and secures a satisfactory level of foreign currency reserves. This will help maintain a stable and credible Palestinian currency when issued.

- PMA is also monitoring domestic currency exchange market and deposit and lending interest rates, and making necessary operational decisions, especially occasional interventions to provide and secure necessary short-term liquidity in the desired currencies to banks, so that they can match supply and demand needs.
- Furthermore, the PMA will strive to pass a new central bank law that enhances its independence and provide the legal coverage for formulating and implementing a comprehensive monetary policy.

The road ahead for monetary policy

Within the frame of its future plans, the PMA is considering the introduction of certificates of deposit (CDs) and manage government bonds and securities (once it introduced) to be initially marketed to banks operating in Palestine. These instruments would promote the stability of the financial system, help develop the local capital market, provide the necessary liquidity to the payments system on a day-to-day basis, and, when appropriate, serve as a form of collateral that banks offer to the PMA against loans. Also, this will help to develop the interbank market by enabling banks to extend loans to one another against such CDs as collateral.

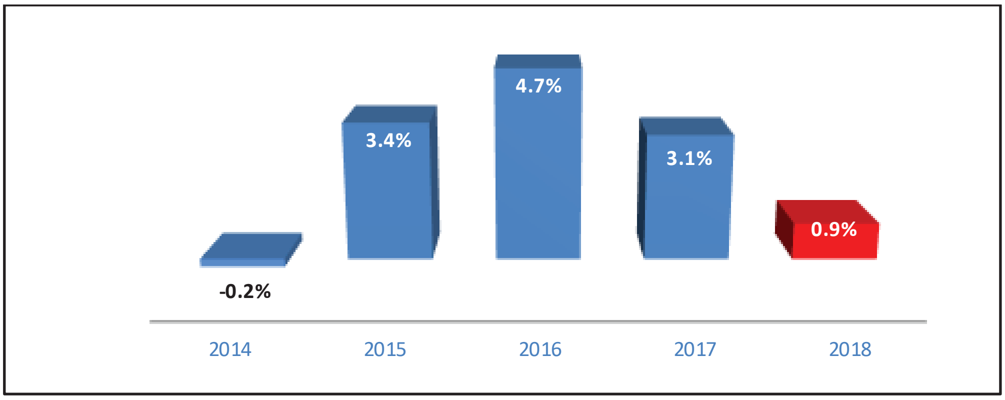
Also, by introducing such instruments, the PMA establishes the use of a vital monetary policy instrument. Therefore, it can create a yield curve and influence interest rates in the local market, even in the absence of a national currency, by offering a benchmark/reference rate of interest that banks will find it difficult to ignore. These instruments can also contribute to promoting PMA's ability to manage overall liquidity in the system by injecting or absorbing money in or out of the market.

Appendix
Main Economic Indicators, 2014-2018

Indicator	2014	2015	2016	2017	2018
Output and Prices	**(Annual percent change)**				
Real GDP (2015 market prices)	-0.2	3.4	4.7	3.1	0.9
Real Per capita GDP	-3.1	0.4	2.1	5.1	-1.7
Inflation rate	1.7	1.5	-0.2	0.2	-0.2
WB	1.2	1.3	-0.1	0.0	0.4
GS	2.9	1.8	-0.9	0.10	-1.3
Unemployment Rate	**(Percent of labor force)**				
Palestine	26.9	25.9	26.9	28.4	30.8
WB	17.7	17.3	18.2	18.7	17.6
GS	43.9	41.1	41.7	44.4	52.1
Consumption, Investment and Saving	**(Percent of nominal GDP)**				
Final consumption	117.2	120.2	118.2	113.2	113.7
Gross capital Formation	20.0	21.1	21.2	22.6	23.7
Saving	5.3	4.5	5.1	10.8	11.6
Public Finance	**(Percent of nominal GDP)**				
Total net revenue and Foreign Aid	31.6	29.1	32.1	30.2	28.2
Total expenditures	28.3	28.4	28.9	27.9	26.9
Overall balance (Excl. foreign aid)	-6.4	-5.6	-2.4	-2.7	-3.3
Overall Balance (Inc. foreign aid)	3.3	0.7	3.3	2.3	1.3
Government public debt	17.4	20.0	18.5	17.5	16.2
External Sector	**(Percent of nominal GDP)**				
Exports of Goods and Services	17.1	18.4	17.7	18.6	19.9
Imports of Goods and Services	56.7	59.5	56.8	55.6	59.7
Income from Abroad, net	11.7	13.5	14.1	13.7	16.4
Current transfers, net	11.1	11.2	10.5	12.5	12.1
Current Account	-16.9	-16.3	-14.5	-10.8	-11.4
Monetary Sector	**(Annual percent change)**				
PMA Assets	-0.6	10.0	9.8	8.5	3.2
Banks Assets	5.6	6.6	12.7	11.6	1.7
Direct Credit Facilities	9.3	19.0	18.0	16.8	5.1
Customer Deposits	7.6	8.1	9.8	13.0	2.0
Balances Abroad	5.9	-16.5	11.1	-19.4	-7.2
Ownership Equity	7.7	0.0	14.9	12.4	1.1
Real GDP (USD Million,2015 = 100)	12,252.9	12,673.0	13,269.7	13,686.4	13,810.3
memorandum items					
Nominal GDP (USD Million)	12,715.6	12,673.0	13,425.7	14,498.1	14,615.9

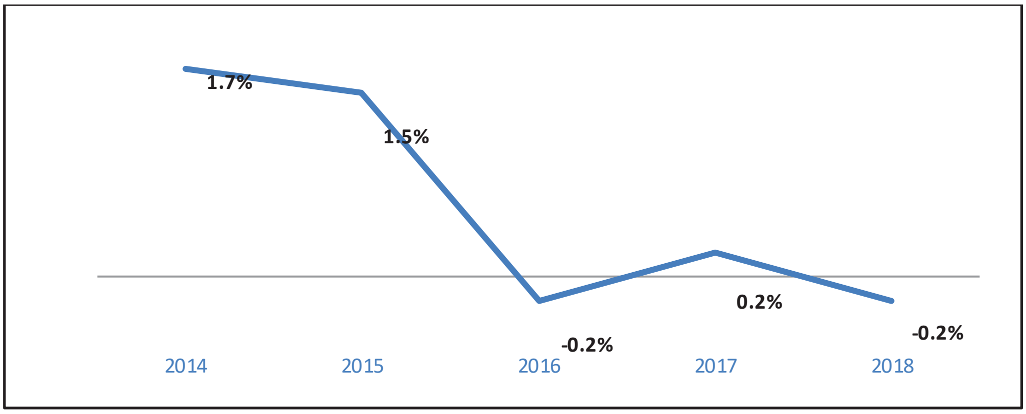
Indicator	2014	2015	2016	2017	2018
Al-Quds Stock Market Index (point)	511.8	532.7	530.2	574.6	529.4
Exchange rate (USD/NIS)	3.57	3.89	3.81	3.61	3.59

Figure 1: Annual Economic Growth, 2014-2018



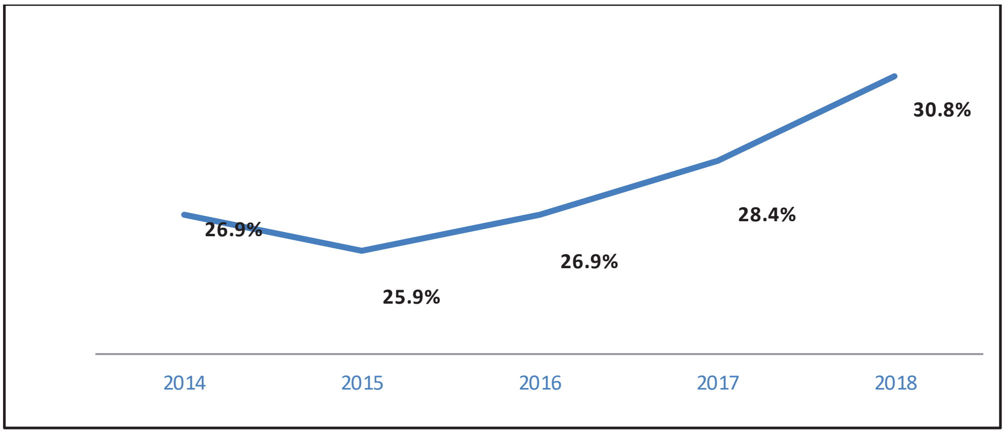
Source: Palestinian Central Bureau of Statistics (PCBS).

Figure 2: Annual Inflation Rate, 2014-2018



Source: Palestinian Central Bureau of Statistics (PCBS).

Figure 3: Unemployment Rate, 2014-2018



Source: Palestinian Central Bureau of Statistics (PCBS).

Central Bank Background Papers on Monetary Policy Frameworks in the Arab Countries

AMF - BIS Third Working Party Meeting on

Monetary Policy in the Arab Region

The State of Kuwait

Central Bank of Kuwait

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13-14th November 2019

Monetary Policy Implementation in The State of Kuwait

Overview

As defined in Paragraph (A) of Article (41) of Law No. 32/1968 concerning Currency, the Central Bank of Kuwait, and the Organization of Banking Business, the Discount Rate is "the interest rate charged by the Central Bank of Kuwait (CBK) against the discount or rediscount of commercial papers, provided that these shall mature within one year from discount or rediscount by the Bank". Paragraph (D) of Article (26) of the CBK Law states that "within the provisions of this Law, the Board of Directors shall exercise the full powers necessary to perform its duties, and particularly, shall fix the rates of discount, rediscount, interest and commission to be charged by the Bank on loans, advances and discount of commercial papers." Worth noting is that CBK's Board of Directors' resolution No. 3/220/1995, issued on 30th January 1995, has waived the minimum limits of interest rate on deposits and saving accounts while maintaining the maximum limits of interest rate on loans.

In light of the above-mentioned, CBK's disclosed Discount Rate is considered a central rate to which the maximum limits of the contractual interest rate on the KD loans are linked to within narrow margins. Hence, CBK's Discount Rate increase entails an equal increase in the maximum limit of interest rate on the KD loans and vice versa. In accordance with CBK Board of Directors' resolution No. 29/338/2008, issued on 23 March 2008 on the maximum limits of the annual contractual interest rate, the maximum limit of interest rate on consumer loans and installment loans granted in KD may not be more than 3 percent (three percent) over CBK's discount rate. Installment loans shall be granted against fixed rates, provided that the applicable interest rate shall be reviewed every five years during the loan tenor.

In accordance with this resolution, the terms concerning the maximum limit of interest rate on all forms of commercial lending and other forms of lending denominated in KD, shall not exceed 2.5 percent (two and a half percent) over

CBK's discount rate for lending transactions denominated in KD and which tenor does not exceed one year, while the annual interest rate ceiling on KD shall not exceed 4 percent (four percent) over CBK's discount rate for lending transactions denominated in KD and which tenor does not exceed one year. The linking of the maximum limit on the interest rate on lending transactions denominated in KD became effective by virtue of CBK Board of Directors' resolution No. 30 issued in November 1988.

In this respect, CBK's Discount Rate is determined through monitoring the domestic and global economic, monetary and banking conditions, as well as indices of general economic performance, oil sector performance and developments in credit and deposits growth indices. Accordingly, the CBK adjusts the Discount Rate either upward or downward with the aim of achieving the CBK's monetary policy goals to support monetary and financial stability and enhance sustained economic growth in the national economy.

On the other hand, some of the domestic economic structural characteristics, shape the economic environment within which the tools and goals of the monetary policy of the CBK operates. These are mainly the small size of the Kuwaiti economy and its sensitivity to the changes in the global markets, free movement of funds with other countries, and its openness to the outside world in terms of reliance on oil revenues, as well as its reliance on goods and services imported from other countries. In this type of economic environment, CBK is keen on framing and implementing its monetary policy to support monetary and financial stability, control imported inflationary pressures, and enhance sustained economic growth aiming towards economic and social development.

II. Liquidity Conditions & Monetary Policy Framework

Kuwait's banking system has operated in an environment of excess reserves for a number of years due to large oil revenues. Liquidity conditions in the Kuwait's financial system remain ample. Effective liquidity management frameworks are crucial to address liquidity fluctuations, facilitate monetary policy implementation, and avoid liquidity imbalances. Local banks are in a strong position to absorb relatively large liquidity shocks. Banks are able to meet liquidity regulation requirements with ease. As of 2018, Kuwaiti banks are well above the minimum required 100 percent for LCR and NSFR. Loans to Available Sources of Funds was at 76 percent as of end of 2018, below the maximum of 90 percent.

Chart (1)
LCR, NSFR & Loans to Available Sources of Funds

III. The Operational Monetary Policy Framework: The latest developments

The CBK continued its efforts in the area of monetary policy, banking supervision and oversight programs in line with local economic developments on the one hand, and global market developments on the other. The CBK's efforts aimed to strengthen monetary and financial stability, promote a supportive environment to inspire confidence in the national economy and stimulate economic growth. In addition, the CBK reiterated its keenness to reinforce the competitiveness and attractiveness of the national currency, which is considered as a store of domestic savings and is the main currency used in domestic lending extended by local financial institutions to the various sectors of the national economy.

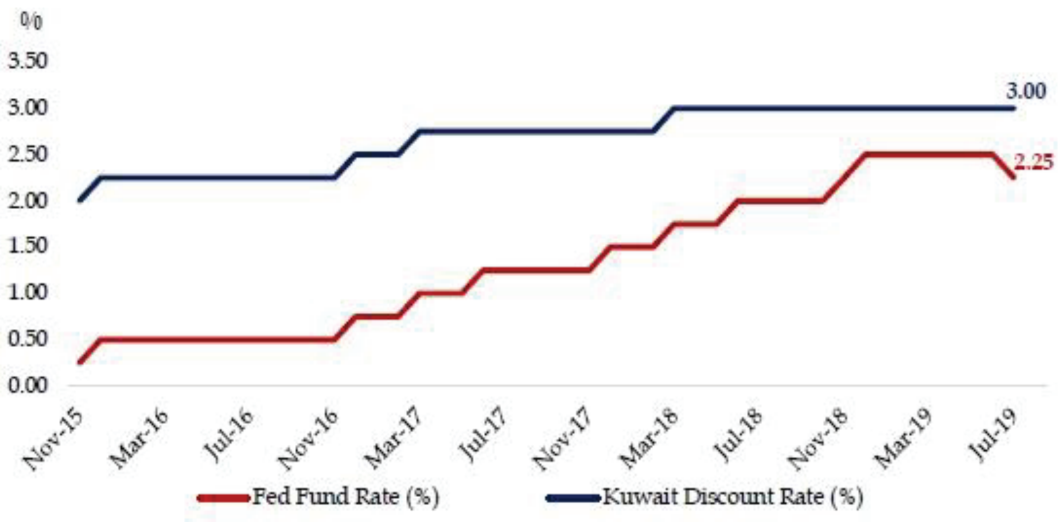
A. CBK Discount Rate

Effective from 16 December 2015, FED has been focusing on returning to a more normalized monetary policy after a prolonged period of almost zero interest rate and the associated Quantitative Easing Scheme. Federal Reserve raised interest rates nine times since 2015 (twice in December 2015 and December 2016, three times in March, June and December 2017, and four times in March, June, November, and December 2018); the interest rate remained unchanged following Fed's five meetings held in 2019. Despite the Fed's hikes and the most recent reduction, the CBK only raised its discount rate four times within the same period and skipped five of the Fed's hikes and the most recent reduction in the interest rate.

The marginal increase in the policy rate enabled the CBK to signal its commitment to maintaining the continued attractiveness of the Kuwaiti Dinar as a store of domestic savings; this is a fundamental objective of CBK's monetary policy. The banks continue to benefit from other monetary policy instruments such as bonds and related tawarruq, deposits from local banks, and direct intervention by the CBK.

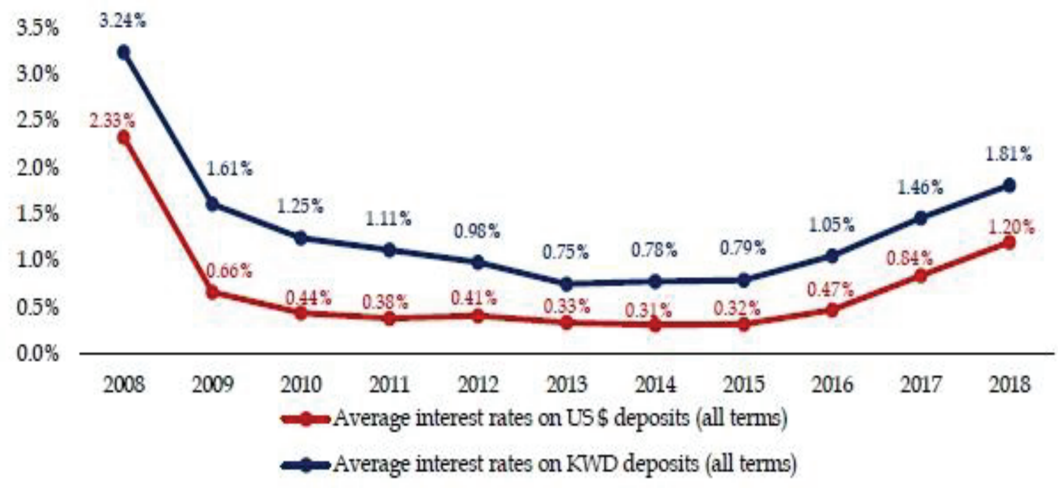
Upon CBK's continuous evaluation of developments in KD interest rates and those of major international currencies, the CBK raised the discount rate by 25 basis points on 22 March 2018 from 2.75 percent to 3.00 percent, which was CBK's latest change to the Discount Rate to date. Despite the Fed's cut in rates on July 31st, 2019, CBK's Discount Rate remains unchanged, given the greater flexibility afforded by the present policy of pegging the KD to a currency basket.

Chart (2)
Discount Rates (Kuwait) & Fed (USA)



The average interest rate on KD deposits was 1.81 percent as of the end of 2018, increasing by 35 basis points compared to the average interest rate of 1.46 percent as of the end of 2017. KD average interest rates remain higher than average interest rates on local USD deposits, which were 1.20 percent as of the end of 2018. The spread between the average interest rate on KD deposits and USD deposits remained steady at an average of 53 basis points from 2013 to 2018.

Chart (3)
Average Interest Rates on Deposits KD vs USD



B. Exchange Rate Stability

Fundamentally sustainable economic growth and appropriate macro policies, both fiscal and monetary, constitute the pillars of exchange rate stability. More specifically, the maintenance of the competitiveness and attractiveness of the KD as the store for domestic savings and investment remains the highest priority for the CBK, which is committed to taking all actions necessary to safeguard the competitiveness of the national currency. The nominal effective exchange rate remained stable, reaching 103.1 as of the end of 2018.

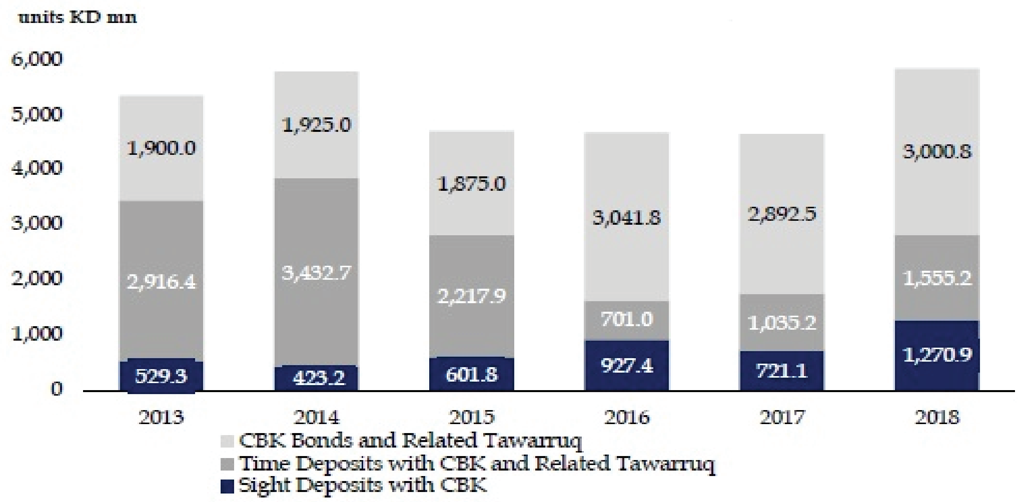
Chart (4)
NEER Imports Weights (100=2010)

C. Money Market Developments

The CBK has a set of tools to manage liquidity. The CBK issues short-term bonds (3-Month and 6-Month), standing deposits, and extends credit facilities to banks. CBK bonds are issued with the amounts, rate, and price determined by the CBK, and the issuances are taking place whenever necessary. The CBK can also engage in repurchase and foreign exchange swap operations and overnight lending facilities. Still, these are not frequently used due to the abundance of liquidity in the system.

Amid improving liquidity conditions, absorption by the CBK during 2018 increased by 21.0 percent compared to 2017. In particular, the share of interventions surged against CBK bonds and related tawarruq, accounting for 51.5 percent of the total absorptions in 2018 compared to 38.9 percent in 2017. In principle, CBK's monetary operations continued to maintain sufficient systemic liquidity while smoothing out fluctuations caused by periodic variations in the volume of funds introduced or withdrawn from the banking system.

Chart (5)
CBK's Absorption Tools

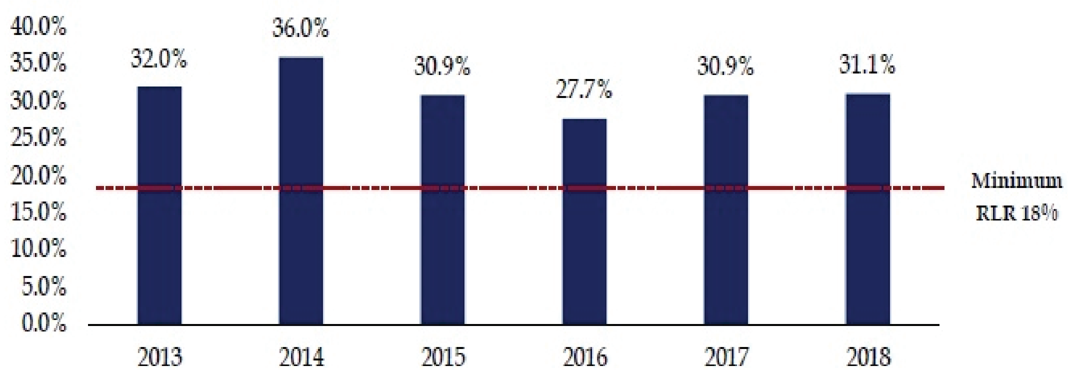


The KD interbank offered rate started in 2018 on a rising trend and continued to rise throughout the year. Interbank one-month offered rates closed the year at 2.1 percent, notably higher than its 2017 closing at 1.7 percent.

The Required Liquidity Ratio (RLR) for Kuwaiti banks was 31.1 percent as of the end of 2018, well above the required minimum of 18 percent. The RLR requires the banks to hold liquidity against all KD customer deposits. They can keep this liquidity in the form of reserves held in their account at the CBK, time deposits at the CBK, and CBK and MoF bonds. Further, they are required to have a minimum holding of each instrument set at 3, 3, 6, and 6 percent of liquid assets held against the RLR, respectively.

Chart (6)

Required Liquidity Ratio



IV. Monetary Policy Implementation: Main Challenges and Reforms

The main challenges for CBK's implementation of monetary policy include;

- The accuracy of liquidity forecasting: CBK has an underway project to update the liquidity forecasting model to enable more accurate forecasts to better manage market liquidity in a manner that will facilitate its implementation of monetary policy.
- Striking a balance between utilizing liquidity surplus without compromising asset quality: This is a key issue that CBK faces, when and how much liquidity needs to be absorbed in the market, which could be significantly enhanced with an accurate liquidity-forecasting model.
- The fourth industrial revolution and FinTech development: The fast-paced developments in financial technology are reshaping financial markets, in particular, Fintech innovations and the emergence of new payment tools and settlement systems. This poses both a challenge and an opportunity for central banks and supervisory authorities to adjust monetary policy and financial stability frameworks accordingly.

V. Conclusion

The present policy of pegging the KD exchange rate to a basket of currencies has served the country well, delivering monetary policy credibility and low inflation. However, there is a limit to what monetary policy alone can do. Hence, fiscal and structural policies are called for properly addressing future challenges. Also, the present status quo of monetary policy and macroprudential policies may be disrupted by external events such as geopolitical events and a drop in oil prices.

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The Republic of Lebanon

Banque Du Liban

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Monetary Policy Implementation in The Republic of Lebanon

Overview

Unstable political circumstances in the country, along with regional unrest and the burdens of the Syrian crisis, have impaired the Lebanese economy for several years now. The political vacuum caused by the absence in presidency for two-and-a-half years and a nine-month absence of a government in 2018 further exacerbated the economic environment. As a result, the main economic indicators, such as foreign investment, tourism, and real estate, marked their lowest levels since 2011.

GDP growth stood at around 1 percent compared to 2 percent growth in the region, while the inflation rate reached approximately 6 percent. Lebanon's singularity, however, continues to lie in its resilience and its unique ability to prevail under exceptionally arduous social, political, and economic pressures.

At the monetary front and despite the recent rise in demand for dollar banknotes, Banque Du Liban (BDL) is maintaining its commitment to exchange rate stability, which has become the cornerstone of financial stability in Lebanon. In fact, BDL is deploying all its efforts to ensure that monetary stability is safeguarded. With its solid stock of foreign assets accumulated over the years, BDL remains well-equipped to confront any economic crisis.

A reliable banking system has been established in strict compliance with international banking and accounting standards, particularly with respect to capital adequacy, good governance, transparency, profitability, liquidity, and combating money laundering. The Lebanese banking sector has thus the appropriate regulatory and supervisory frameworks to maintain its resilience and strength and to withstand unexpected events.

In spite of challenges that hampered its progress, the banking sector's performance remained healthy, recording an annual growth of 10 percent in total assets of banks, which exceeded USD 261 billion in August 2019. Bank deposits stood at USD 182 billion, with a decrease of 0.79 percent since December 2018 (chart 1). In parallel, bank loans to the private sector stood at USD 57.5 billion at the end of August 2019, as compared to 61.7 at the end of 2018 (chart 2). The dollarization of deposits reached 72 percent, up from 70.62 percent last year, while the loan dollarization ratio witnessed a slight increase of less than 1 percent since December 2018, registering 60.95 percent by end August 2019.

Chart (1)
Total Private Sector Deposits of Commercial Banks
(in millions of USD)

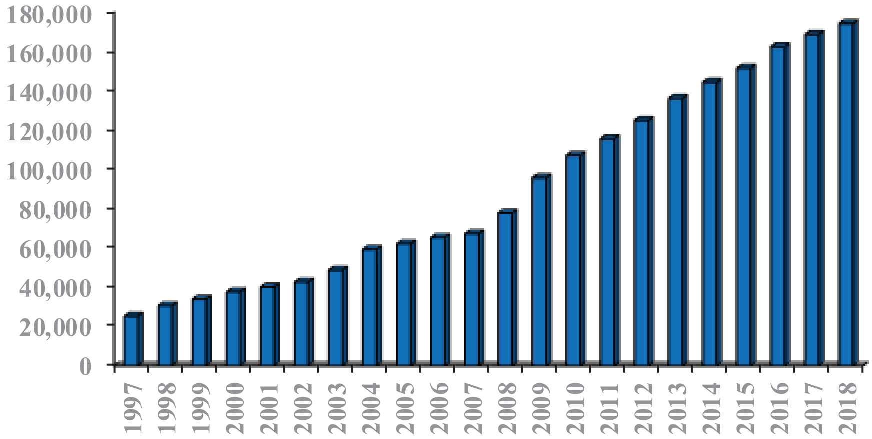
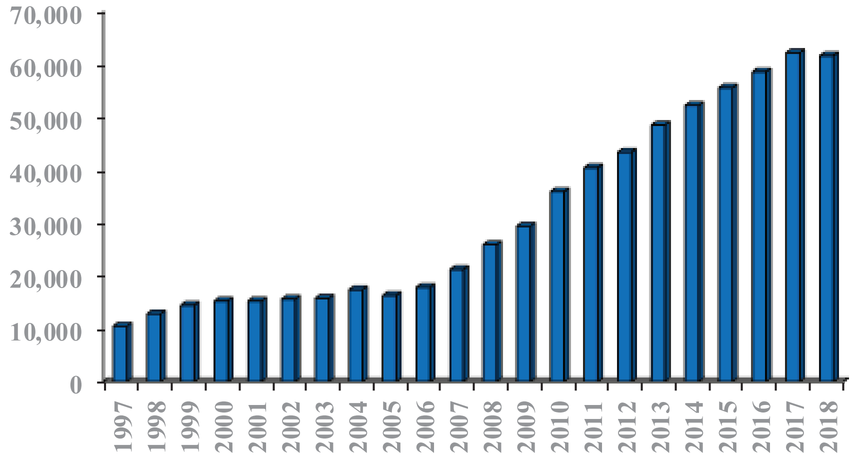
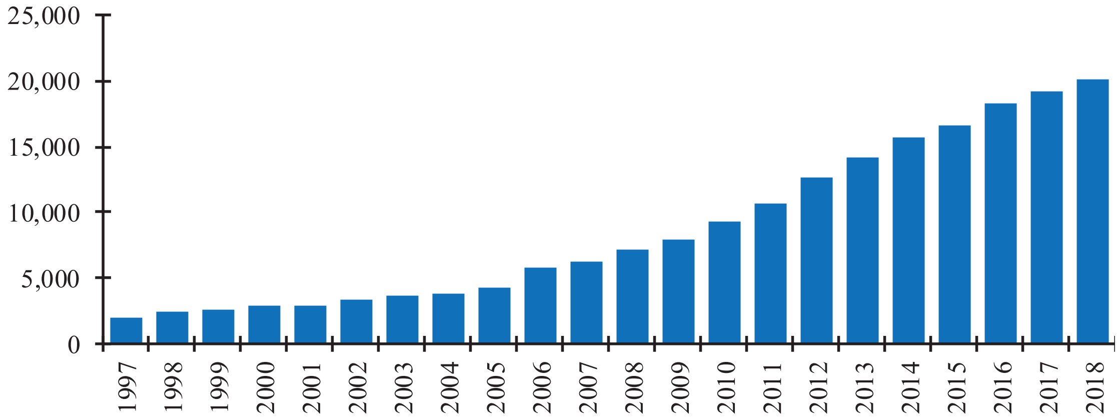


Chart (2)
Total Banks' Loans to the Private Sector (in millions of USD)



In terms of capitalization, BDL has been keen to reinforce banks' capitalization in a way to enable banking institutions to confront any crisis that may hit the economy. With a capital base exceeding USD 20 billion in August 2019 (chart 3), banks were able to reach a high capital adequacy ratio of 16 percent much higher than the ratio required according to Basel III and more particularly to build general reserves. A downgrade in Lebanon's credit rating would bring down this ratio to around 12 percent, which is still largely exceeding the requirements of Basel III.

Chart (3)
Commercial Banks' Equity (in millions of USD)



The Operational Framework of Monetary Policy in Lebanon: Objectives and Instruments

BDL's mandate includes safeguarding the national currency and maintaining financial and economic stability. Its main functions consist of the issuance of the national currency, regulating the money supply, controlling interest rates, setting the monetary policy, and overseeing and developing the banking and financial sectors. BDL's policies are considered the foundation for sustained social and economic growth in Lebanon, as much as for the development of the banking sector, which is considered one of the strongest sectors in the Lebanese economy. In order to fulfill its mandate, and particularly safeguarding monetary and economic stability, BDL resorts to conventional tools as well as nonconventional ones as needed.

A. Conventional Monetary Policy Tools

For the past two decades, BDL's monetary policy has been first and foremost targeted at stabilizing the Lebanese pound exchange rate and controlling inflation. The central bank's continuous commitment to a stable exchange rate has proved to be key in the stability of the financial system.

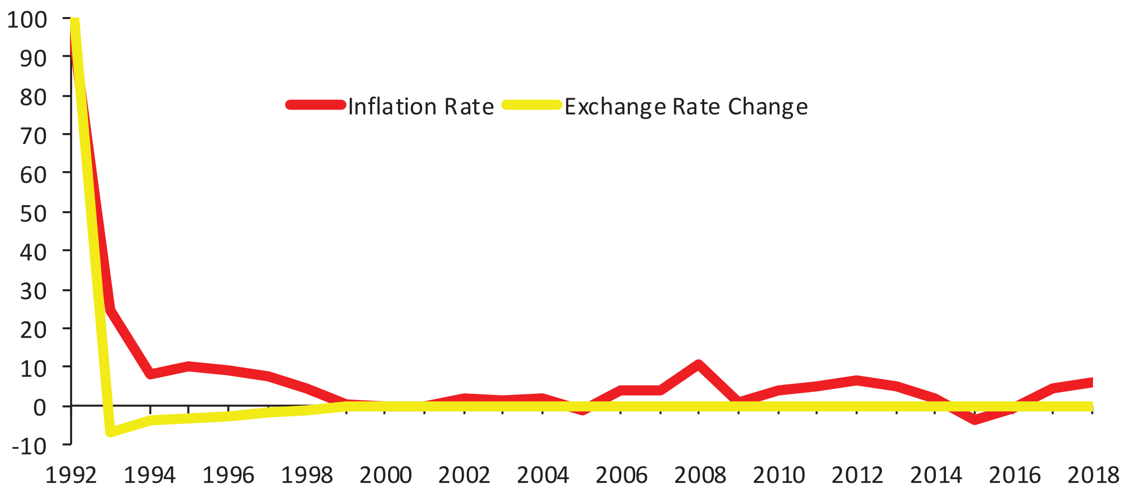
1. Maintaining Exchange Rate Stability

After the deterioration of the Lebanese pound (LBP) during the 1980s and early 1990s, BDL has realized that maintaining monetary stability using the exchange rate as a nominal anchor is an essential prerequisite for financial stability. BDL has followed a managed exchange rate regime, keeping the LBP-USD rate within a narrow band that has been set at LBP 1501-1514 to the dollar. A gradual appreciation of the Lebanese pound was recorded over the 1992-1999 period, followed by relative stability since then. Drastic price containment came along with exchange rate appreciation.

2. Maintaining Low Rates of Inflation

The three-digit inflation rate that crippled the Lebanese economy in the early 1990s has been successfully contained at a single-digit rate over the past twenty years. With the public sector wage hike approved in 2017 and the increase in oil prices, the inflation rate has increased from 4.5 percent in 2017 to reach around 6 percent in 2018. (chart 4).

Chart (4)
Inflation Rate versus Exchange Rate Change

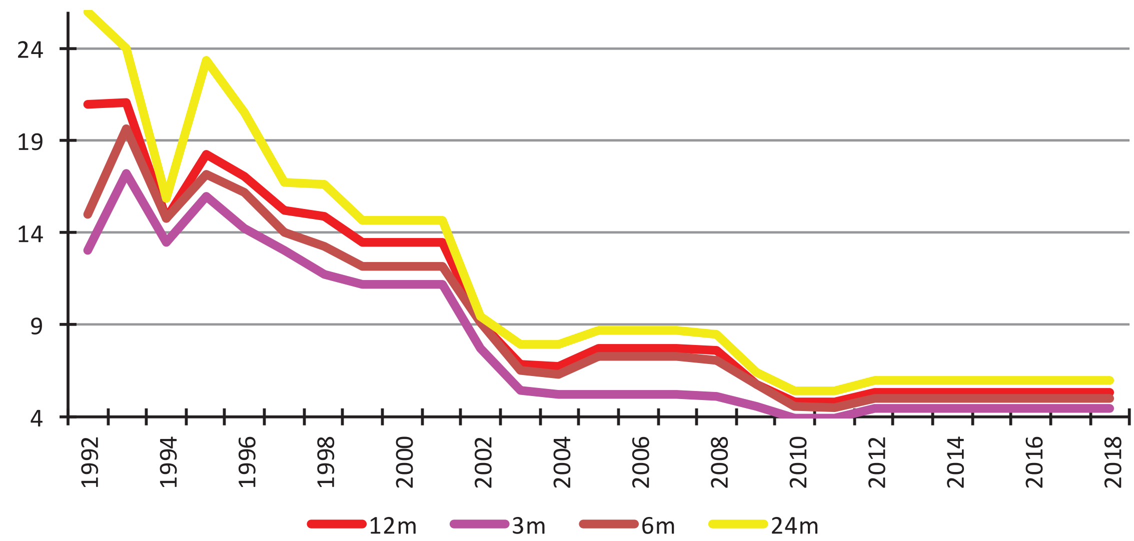


3. Ensuring a Gradual Decrease in Interest Rates

BDL's compliance with market tendencies in the determination of interest rates maintained the latter at appropriate levels to spur capital inflows and strengthen the external position. Growing confidence in the local currency has resulted in gradual interest rate cuts since the 1990s.

The massive cash injection into the Lebanese market during 2008-2010 has also helped the interest rate structure to decline further, which resulted in debt service savings over the past years. Starting in 2018, interest rates were witnessing an increase, in line with market tendencies and a global increase in interest rates, thus accounting for a rise in the budget deficit. (chart 5).

Chart (5)
Primary Market Rates on Treasury Bills



B. Non-conventional Monetary Policy Tools

The pressing regional and local challenges that have hindered the Lebanese economy for the past few years have incited BDL to resort to unconventional monetary policy tools to boost socio-economic development.

1- Stimulus Packages

BDL launched its first stimulus package amounting to USD 1.47 billion back in 2013. These credit incentives, provided through the banking sector, have played a key role in boosting and supporting the numerous segments of the Lebanese economy, fostering traditional sectors through productive loans; development of human capital and entrepreneurship through education, research and development, and knowledge and innovation loans; reinforcement of the middle class through housing loans; preservation of the environment through green incentives.

During the past seven years, the stimulus packages have amounted to USD 7.2 billion and have targeted productive sectors (40 percent) and the housing sector (60 percent). These incentives, together with the exemption of banks from reserve requirements and government loan subsidies, have led to the injection of almost USD 16 billion to support economic activity since 2009. The importance of these catalyst endeavors lies in their sizable contribution to real GDP, and their momentum in job creation.

Recently, BDL has taken additional measures to support the Lebanese industry sector by increasing the percentage of BDL contribution to the industrial subsidized loan, thus enabling commercial banks to provide the necessary loans to industrialists, including working capital. Moreover, BDL has increased the ceiling of the loan granted to finance the working capital from USD three million to USD five million.

2- Equity Financing and Knowledge Economy

Supporting productive sectors is essential yet not sufficient alone to boost Lebanon’s economy. Sustainable growth and development are largely linked to improving Lebanon's competitiveness, with the knowledge economy playing a pivotal role. Considering that the wealth of Lebanon lies in its pool of high skilled labor, and aiming at enhancing its innovative potentials, BDL launched in August 2013 a new initiative enabling banks to contribute, for the first time, in the equity financing of startup companies, incubators, accelerators, and venture capital. This has come in conformity with the belief that the market economy and the enhancement of entrepreneurship are the right approaches for creating wealth and job opportunities in Lebanon.

By issuing its circular 331 dated August 22, 2013, BDL was the first institution to foster the Lebanese knowledge economy on a national scale by motivating the banking sector to invest around USD 600 million in startups. BDL has been focusing on developing and supporting Lebanon's highly qualified human capital that is capable of effectively turning innovative ideas into successful businesses and creating job opportunities in the process, thus contributing to economic prosperity.

The Regulatory Framework of Monetary Policy in Lebanon: Stability, Governance, and Compliance

For almost three decades now, BDL has been keen on channeling its efforts towards developing a sound and secure banking sector to build a prudent financial model that inspires confidence in the system. Practices implemented in the Lebanese model are similar to many of the recent reforms suggested by international financial regulators, most important of which are:

- Decreasing leverage,
- Regulating derivatives and structured products,
- Strengthening banks capital and liquidity requirements,
- Enhancing the corporate governance and transparency of financial institutions,
- Enabling the central bank's monitoring of all financial players,
- Enhancing financial inclusion,
- Drawing a clear demarcation between commercial banks and investment banks, and
- Prohibiting any defaulting of banks that threatens financial stability.

Furthermore, intensive actions have been enacted towards implementing compliance measures with respect to Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT), risk management and effective internal control, and global sanctions.

During the past two years, BDL has persisted in implementing major regulatory measures that are consistent with the above-mentioned practices. The most significant of these measures can be highlighted as follows:

- Enhancing financial inclusion: BDL has issued circulars that encourage banks to establish branches in remote areas and install ATMs that are accessible by people with special needs. Furthermore, BDL has permitted the establishment of a new category of financial institutions to be limited to micro-financing.

- Reinforcing banks' reserves in consistence with IFRS9 standards: BDL issued the necessary regulations that require banks to constitute the reserves needed to cover expected credit losses and retail loans, according to IFRS9 standards.

- Strengthening corporate governance: BDL has directed banks to set recovery and board members' succession plans.

- Enhancing transparency and protecting against cybercrime acts: BDL has required banks to enact common reporting standards that are related to the disclosure of tax information to the Ministry of Finance, in addition to compelling banks to take the necessary measures for protection against cybercrime acts. Moreover, BDL has demanded that banks comply with the General Data Protection Regulation (GDPR) for personal data protection.

- Boosting AML/CFT compliance measures: BDL has enacted and determined the notion of "beneficial owner" in the financial and banking operations control system for combating money laundering and financing of terrorism. In addition, BDL has required banks to introduce clear justification for any AML/CFT measures.

- Reducing systemic financial risks: BDL has required banks to acquire its approval for any mandatory contributions, partnerships, placements, and deposits required by laws, regulations, and/or authorities at foreign host countries. In addition, BDL committed banks to maintain a liquidity coverage ratio that reflects their self-assessment of liquidity risk and commensurate with the characteristics of the liquidity risk they may be exposed to.

- Enacting Electronic Transactions and Personal Data Law: BDL has contributed to the preparation of the draft law on electronic transactions and personal data, which has been passed by the Lebanese Parliament in October 2018. This long-awaited law recognizes electronic support and electronic signature, in addition to regulating electronic payment orders, electronic transfers, bank cards, electronic money, and electronic cheques.

- Expanding digitalization: on the front of financial technology, the Central Bank has established a committee in charge of issuing the circulars needed for the development and regulation of the fintech sector, based on the Code of Money and Credit and the incoming law related to electronic transactions. In parallel, BDL has made significant progress in the project of establishing a digital currency, and it is finalizing its legal aspect before its launching. BDL has also set the stage, through the Capital Market Authority (CMA), for launching the electronic trading platform that will ensure that active financial markets attract the necessary liquidity for the growth of various economic sectors and open multiple options to obtain required funding for SMEs and other corporations in Lebanon.

Conclusion

Since its inception, the Central Bank of Lebanon has been keen on safeguarding the national currency and maintaining financial and economic stability. And it never spared any efforts to ensure the resilience and soundness of the Lebanese economy in general and the financial sector in particular.

The policies were undertaken by BDL, whether conventional or not, have proven their effectiveness and have been recognized as significant drivers of the Lebanese economy. BDL will remain vigilant to the financial and economic needs of Lebanon and will continue to be proactive in light of persisting challenges.

Nonetheless, to ensure sustainable development and to pave the way for real inclusive growth, the government needs to undertake several structural reforms: revamping infrastructure, enhancing the quality and quantity of public services, simplifying and modernizing administrative procedures, enforcing fiscal discipline, reforming the energy sector, and passing the budget law, among others. Furthermore, BDL has strived to create an adequate environment to promote the banking and financial sectors on the one hand, and the knowledge ecosystem on the other, with the expectation that the government would, in turn, support the creation of the necessary environment for a cross-sectorial and diversified productive economic growth.

Central Bank Background Papers on Monetary Policy Frameworks in the Arab Countries

AMF - BIS Third Working Party Meeting on

Monetary Policy in the Arab Region

The Arab Republic of Egypt

The Central Bank of Egypt

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13-14th November 2019

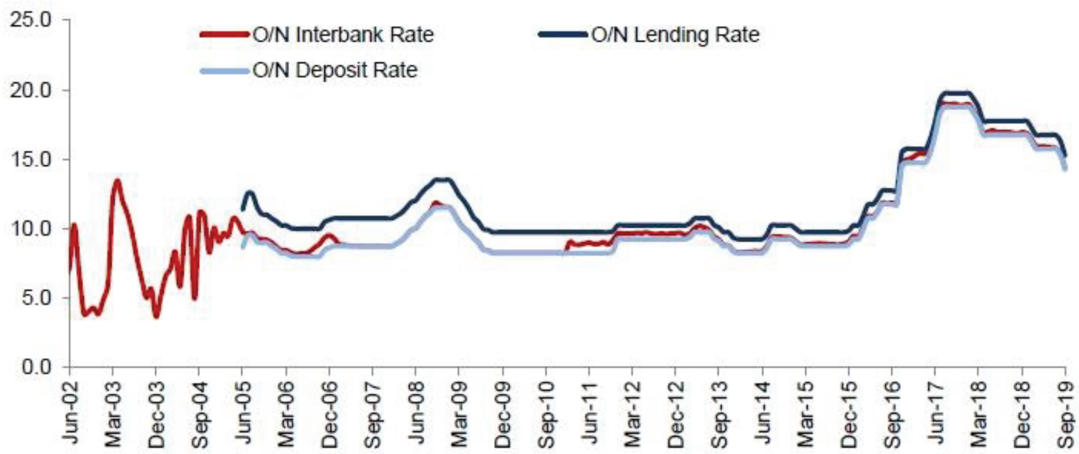
Monetary Policy Implementation in The Arab Republic of Egypt

Evolution of the Monetary Policy Framework

In June 2005, as a step towards transitioning to an inflation targeting regime, the operational target for monetary policy shifted towards a price target, defined as the overnight interbank rate, from a quantity target that was defined as excess reserves. The Central Bank of Egypt (CBE) launched two overnight standing facilities, one for deposits and one for lending, which define a corridor within which the overnight interbank rate fluctuates, thus limiting its volatility. The policy stance is implemented using indirect policy tools, such as open market operations, but if warranted, reserve requirements may also be employed. To signal its policy stance, the CBE announces changes to the corridor rates, in addition to the rate of the main operations.

Chart (1)

Overnight Interbank Rate and CBE's Policy Rates



Source: Central Bank of Egypt.

The description of the monetary policy regime during that time could be expressed as a regime with an implicit rather than explicit nominal anchor, given that quantitative inflation targets and target achievement horizons were not announced. However, following the liberalization of the foreign exchange market in November 2016, quantitative inflation targets and target achievement horizons were explicitly announced, in addition to money targets that were set consistent with the inflation targets.

The inflation targets were set on a declining path to achieve price stability while preserving macroeconomic stability. For 2020, Q4, the inflation target was set at 9 percent (±3 percentage points), down from the previous target that was set at 13 percent (±3 percent-age points) for 2018, Q4, which marked the first announced target in the history of the CBE, and which was successfully achieved.

Furthermore, it was announced that monetary policy tools are utilized to anchor inflation expectations, contain demand-side pressures and second-round effects resulting from supply shocks, and that exogenous factors that are outside the scope of monetary policy may lead to transitoESSry deviations from pre-announced target rates, thereby clarifying when monetary policy should react and providing an escape clause for the inflation target achievement, respectively. Transparency further increased via enhancing the press releases following the Monetary Policy Committee meetings every six weeks, and the publication of quarterly monetary policy reports since March 2017 that assess initial economic conditions and provide an inflation outlook as well as underlying assumptions.

Recent Macroeconomic Developments

In November 2016, the Egyptian authorities launched a homegrown economic reform program, that was supported by a three-year Extended Fund Facility by the International Monetary Fund, to address macroeconomic imbalances and deep-seated structural challenges that held back the Egyptian economy. The main elements of the program were:

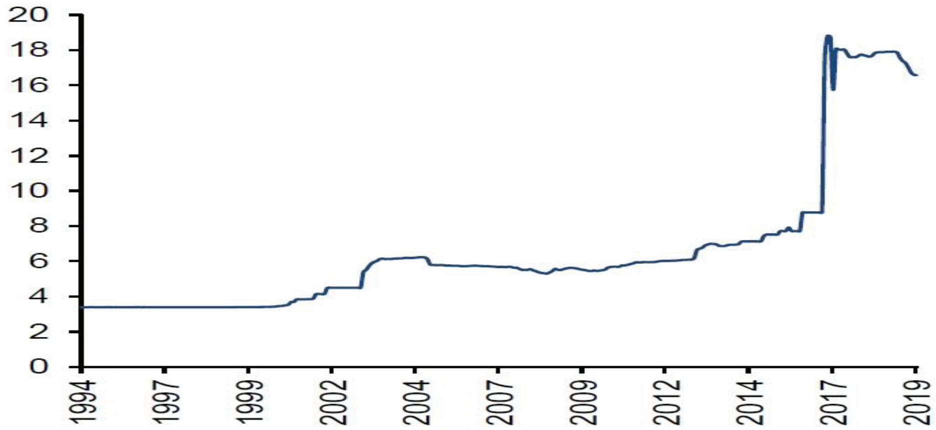
(i) Macroeconomic stabilization policies that include liberalizing the foreign exchange market to eliminate external imbalances as well as tightening the monetary policy and fiscal policy stance to contain inflationary pressures and reduce debt to sustainable levels, respectively;

(ii) Structural policies to promote higher, private sector-led inclusive growth and job creation; and

(iii) Strengthening social protection to ease the burden of the macroeconomic adjustments on the most vulnerable members of society.

Chart (2)

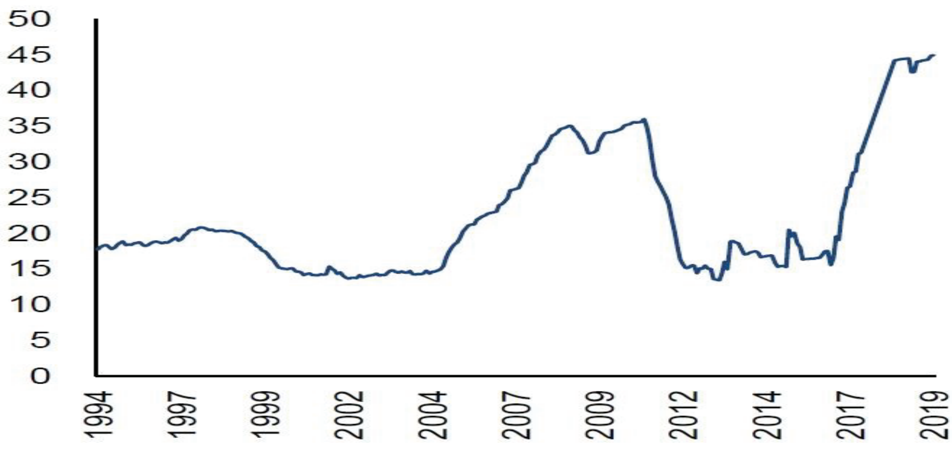
EGP/USD[14] (In Level, eop)



Source: Central Bank of Egypt.
1/2019 includes data up to August 2019.

Chart (3)

CBE's Gross International Reserves (In USD billion, eop)



Source: Central Bank of Egypt.
1/2019 includes data up to August 2019.

The change of the monetary policy regime to a liberalized exchange rate system, combined with a prudent interest rate policy and strong fiscal consolidation have helped stabilize Egypt's macroeconomic environment. Economic growth has

[14] Using estimated imports of goods in 2018/2019.

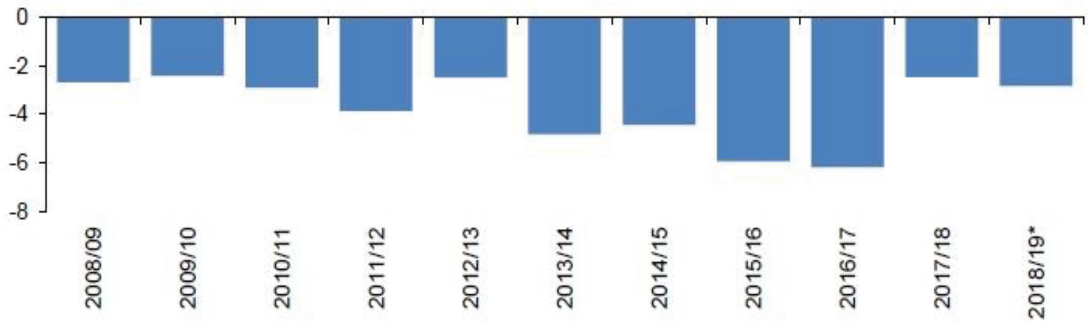
accelerated; external and fiscal deficits have narrowed as a percent of GDP; international reserves have risen; and public debt as a percent of GDP, inflation, and unemployment rates have declined.

The foreign exchange market continued to function orderly after all foreign exchange controls were lifted, leaving the exchange rate to be determined by supply and demand in the market and to act as a shock absorber to maintain competitiveness and to avoid the build-up of external imbalances. As a result, the current account deficit declined to 2.4 percent of GDP in 2017/2018 and is expected to record 2.7 percent of GDP in 2018/2019, compared to 6.1 percent and 5.9 percent of GDP in 2016/2017 and 2015/2016, respectively.

Meanwhile, gross international reserves recorded USD 44.9 billion in August 2019, the highest on record, and is estimated to cover 8.1 months of imports of goods, and more than double the level of reserves in August 2016 that covered 3.5 months of imports of goods prior to the economic reform program.

Chart (4)

Current Account Excluding Public Grants (In percent of GDP)

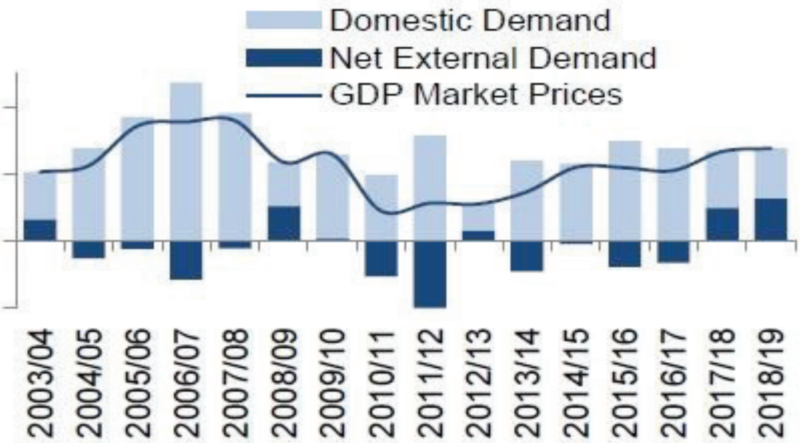


Source: Central Bank of Egypt.
1/2019 includes data up to August 2019.

Higher net external demand for Egyptian goods and services reinforced a more balanced expenditure structure in the economy and supported the rebound of economic growth to a preliminary 5.6 percent in 2018/19, the highest rate in 11 years, despite the containment of private domestic demand growth.

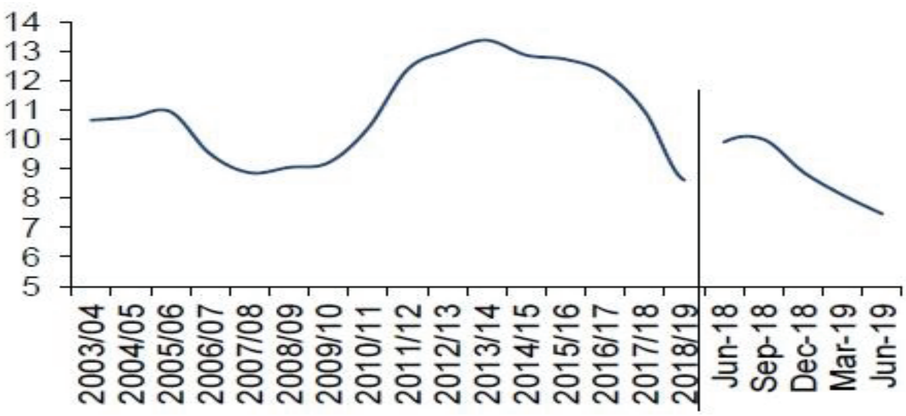
At the sectoral level, output growth by both the private and public sector picked up since 2016 Q4, yet private sector output growth has been softening since 2017 Q3 in line with the tighter monetary stance, while public sector output continued strengthening mainly due to the natural gas extractions activity. Meanwhile, the unemployment rate dropped to its lowest rate on record at 7.5 percent in June 2019, thereby declining by almost six percentage points from its peak in December 2013.

Chart (5)
Contribution to GDP Growth[15]
(In percentage point, y/y)



Source: Ministry of Planning, Monitoring and Administrative Reform.
1/2018/19 represents the average of the first three quarters.

Chart (6)
Unemployment Rate (In percent of the Labor force)



Source: Central Agency for Public Mobilization and Statistics.

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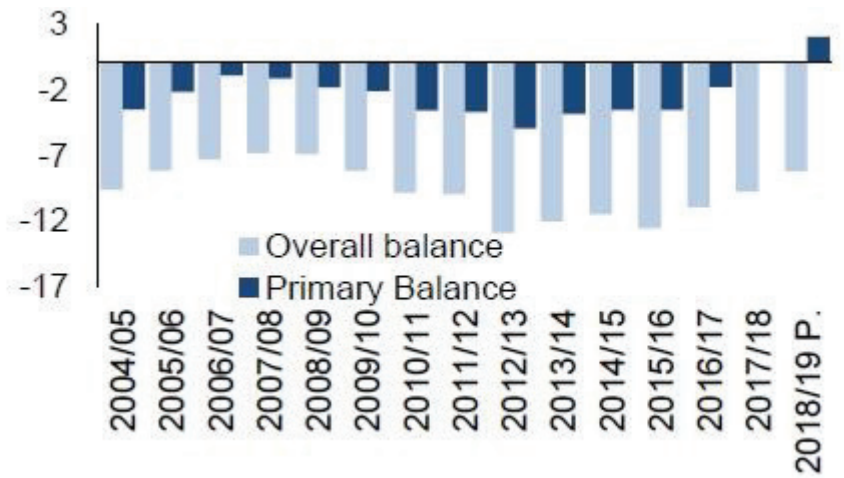
[15] Using estimated imports of goods in 2018/19.

Fiscal consolidation narrowed the overall fiscal deficit to a preliminary 8.2 percent of GDP in 2018/19, down from 12.5 percent in 2015/16, and increased the primary fiscal surplus to a preliminary 2.0 percent of GDP in 2018/19, compared to 0.1 percent of GDP in 2017/18, which marked the first surplus in 15 years, thereby yielding a 5.5 percentage points consolidation over the previous three years. Meanwhile, public debt declined to record a preliminary 90.2 percent of GDP in 2018/19 after peaking at 108.0 percent of GDP in 2016/17.

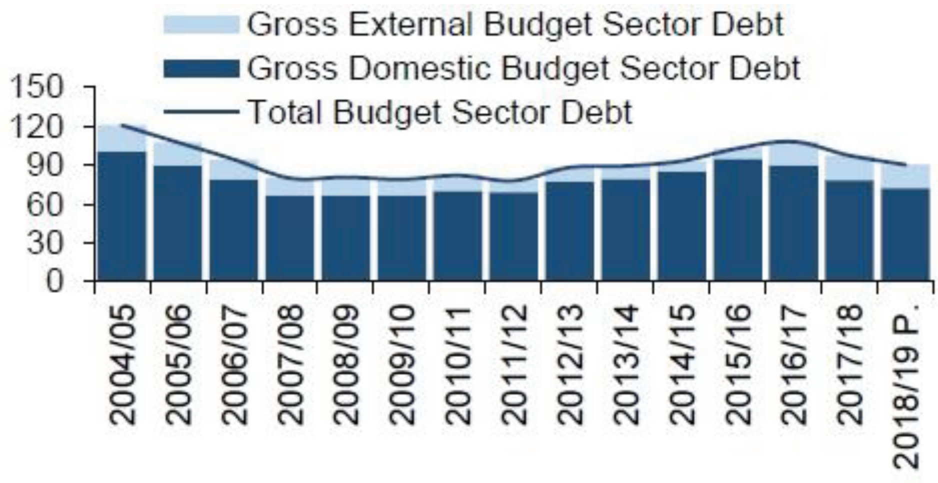
Furthermore, the financing structure of the fiscal deficit became more diversified with increasing foreign appetite for Egyptian securities. Portfolio investments returned strongly to the Egyptian market, after being absent for six consecutive years, and international markets were successfully tapped six times between 2017 and 2019 and issued Eurobonds up to 30-year tenors, while all major rating agencies have upgraded the sovereign credit rating.

Chart (7)
Overall and Primary Fiscal Balance (In percent of GDP)



Source: Ministry of Finance.
1/2018/19 P. represents preliminary estimates.

Chart (8)
Budget Sector Debt (In percent of GDP)



Source: Ministry of Finance.
1/2018/19 P. represents preliminary estimates.

In this environment, monetary policy was challenged to initiate a disinflation path to achieve its mandate of price stability over the medium term and to contain inflationary pressures from the external and fiscal adjustments that led annual headline and core inflation to peak at 33.0 percent and 35.3 percent in July 2017, respectively. Accordingly, the Monetary Policy Committee decided to raise key policy rates by a cumulative 700 basis points between November 2016 and July 2017, and monetary policy implementation introduced longer-term auctions for liquidity-absorbing operations.

With the containment of inflationary pressures, the Monetary Policy Committee has so far reduced policy rates by a cumulative 450 basis points[16].

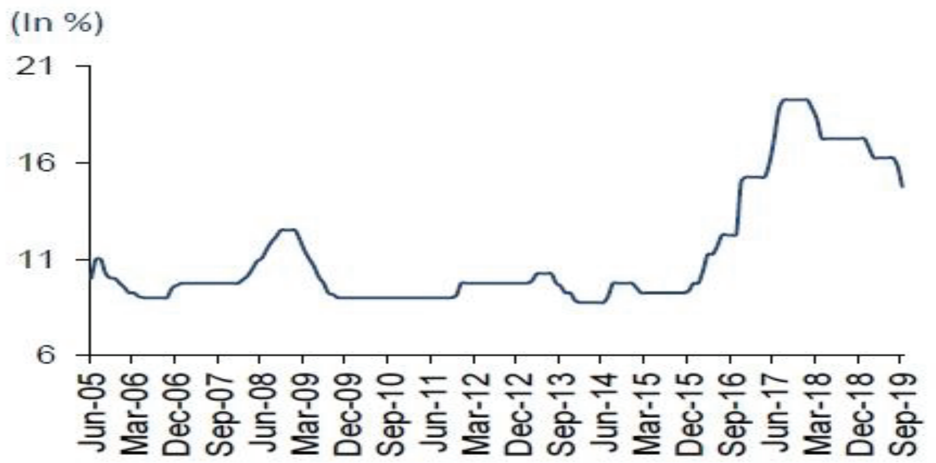
The transmission of policy rate hikes to broader interest rates in the economy was strong, notwithstanding the effect of increased foreign demand on the rates of government securities.

Accordingly, broad money growth declined to an average of 11.6 percent in 2019 Q1, reaching its lowest level in six years, before stabilizing around this level in

[16] As of the cut-off date September 1, 2019. On September 26, 2019 the MPC decided to cut key policy rates by 100 basis points.

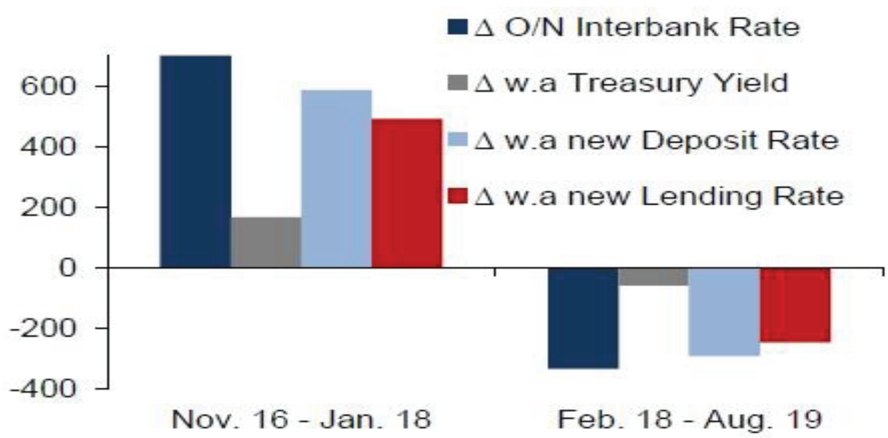
2019 Q2. Meanwhile, dollarization ratios continued to fall, and money holding behavior continued to normalize as measured by currency to deposits or GDP ratios.

Chart (9)
CBE's Key Policy Rate



Source: Central Bank of Egypt.

Chart (10)
Transmission of Policy Rate Changes to Financial Sector Rates[1/]



Source: Central Bank of Egypt.

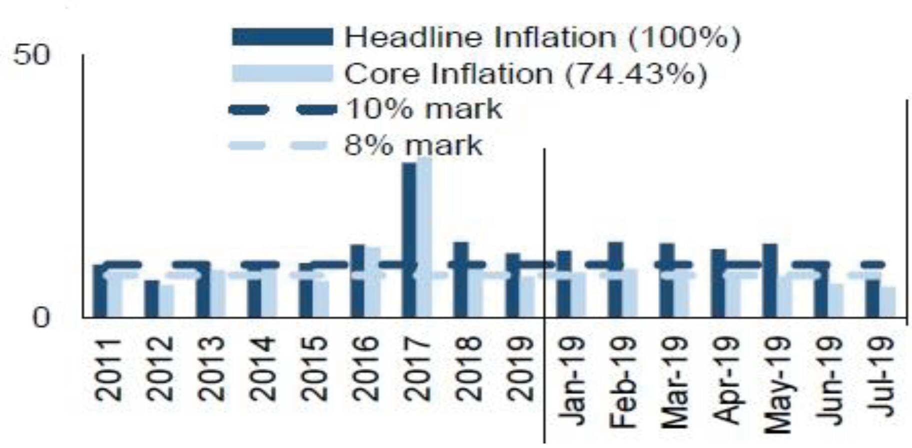
1/ Rates of Government securities are additionally affected by several factors. Banking sector rates are as of July 2019.

Meanwhile, annual headline and core inflation continued to decline to record 8.7 percent and 5.9 percent in July 2019, respectively, the lowest rates in almost four years, notwithstanding the recently implemented fiscal consolidation measures[17].

This decline was supported by (i) strong favorable base effects due to weaker fiscal consolidation measures compared to the previous year, (ii) an appropriate monetary policy stance that contained inflationary pressures, as well as (iii) governmental supply-side measures.

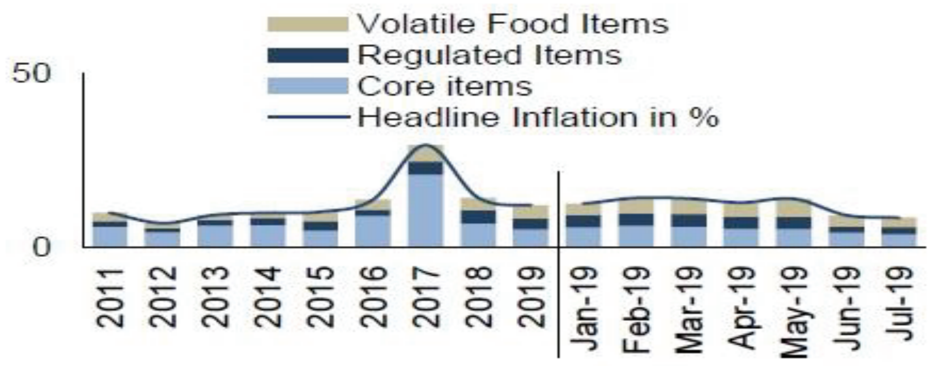
Chart (11)

Inflation Developments[1/] (In percent, y/y, aop)



Source: Central Agency for Public Mobilization and Statistics and the Central Bank of Egypt.
1/ 2019 is the average of the first seven months.

Chart (12)
Annual Contribution to Headline Inflation[1] (In percentage points, y/y, aop, unless otherwise stated)



Source: Central Agency for Public Mobilization and Statistics.
1/ 2019 is the average of the first seven months.

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[17] As of the cut-off date September 1, 2019. On September 10, 2019, August 2019 headline and core inflation continued to decline to record 7.5 percent and 4.9 percent, respectively.

Macroeconomic Outlook

The macroeconomic outlook remains favorable. Inflation is expected to continue trending downwards, supported by an appropriate monetary policy stance. Economic activity is expected to continue strengthening, and structural policies are expected to increase the economy's growth potential, thereby enabling higher, non-inflationary economic growth. Furthermore, as a percent of GDP, the current account deficit is expected to remain contained under the current monetary policy framework, while the primary fiscal surplus is expected to remain stable, and the overall deficit and debt are expected to continue declining.

Chart (13)
Inflation Forcast[1/] (In percent, y/y)

Source: Central Bank of Egypt.
[1/] The chart captures uncertainty regarding the inflation forecast with its most likely evolution, given the risks. The band around the center of the forecast shows the range of inflation outcomes that can occur with 30 percent probability, while the widening bands represent a gradually increasing probability of 50 percent, 70percent and 90 percent.
[2/] The expected higher inflation in the quarter of March 2020 is due to strong unfavorable base effects in the month of December 2019, in the case of absence of the supply shocks witnessed in 2018.

Central Bank Background Papers on Monetary Policy Frameworks in the Arab Countries

AMF - BIS Third Working Party Meeting on

Monetary Policy in the Arab Region

The Kingdom of Morocco

Bank Al-Maghrib

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Abu Dhabi, United Arab Emirates
13-14th November 2019

Monetary Policy Implementation in
The Kingdom of Morocco

Introduction

The conduct of monetary policy in Morocco has undergone several changes in recent years to keep pace with the transformations and developments in the domestic economy and the changing international environment.

Since 2017, two major developments have and are still shaping the conduct of monetary policy. The first one is the launch in January 2018 of the transition towards a more flexible exchange rate regime. This multiphase reform aims to strengthen the resilience of the economy and its ability to absorb shocks. A first step consisted of widening the fluctuation band of the national currency from ± 0.3percent to ± 2.5 percent while maintaining the dirham's reference basket. As for the second development, a new law came into force in July 2019, reinforcing the central bank autonomy, stating its sole responsibility for defining and conducting monetary policy, broadening its intervention scope to financial stability and financial inclusion, and enhancing its governance framework and standards.

As such, and to ensure the conditions for a successful transition to greater exchange rate flexibility, Bank Al-Maghrib (BAM) overhauled its monetary policy analysis and forecasting system (FPAS) as well as its operational framework for its interventions in the foreign exchange market. In parallel, it has developed and deployed a communication strategy, focusing more specifically on preparing economic operators and informing the general public about the implications of this reform, strengthening the forward-looking dimension, and enhancing the transparency of the decision-making process.

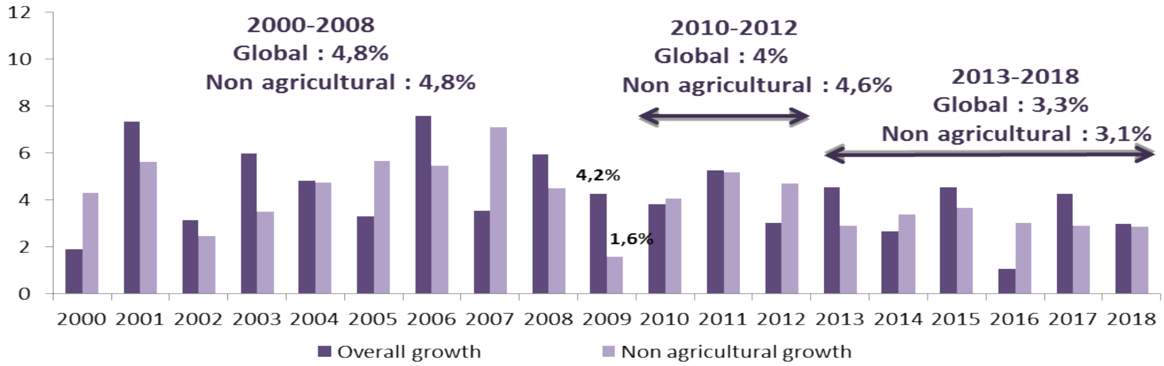
Looking forward, the Bank is developing an inflation targeting framework that will be put in place at the appropriate stage of the flexibilization of the exchange rate regime. This new framework should further strengthen the autonomy of the central bank, enable it to better anchor expectations, and ultimately improve the transmission of its decisions. On another side, in the context of the cross-border expansion of Moroccan banks, particularly in sub-Saharan Africa and the introduction of participatory finance, the Bank continues to strengthen and adapt its regulatory framework of the banking system in line with commonly recognized international standards.

I- Latest domestic economic and financial developments

Over recent years, the global economy had been facing unfavorable headwinds, such as trade tensions, persistent geopolitical upheavals, and political uncertainties, as well as concerns over Brexit. Growth has slowed sharply in a large number of developing and advanced economies, with the notable exception of the United States. Furthermore, oil prices have been very volatile, and inflation has risen significantly both in emerging and developing countries and in advanced economies but remains under the objectives of advanced countries' central banks.

In this generally unfriendly and challenging environment, the Moroccan economy has continued to evolve at a relatively low pace. Indeed, since 2013, non-agricultural growth has hovered around 3 percent compared to 4.8 percent on average between 2000 and 2008.

Chart (14)
National economic growth (percent)



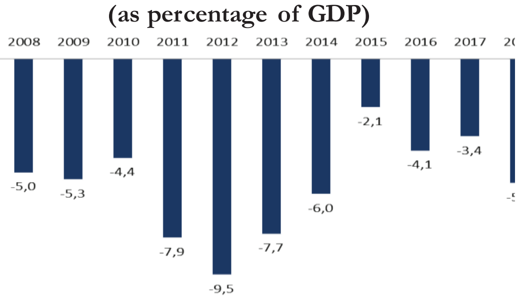
Source: High Commission for Planning (HCP)

The persistence of relatively slow growth has impacted labor market conditions, which have somehow deteriorated in recent years, mainly in terms of employment quality. The participation rate has been on a downward trend, job creation was insufficient, and unemployment globally stabilized while remaining high among the youth.

Inflation continued to evolve at moderate levels, except in 2018, when it surged to 1.9 percent, following the revision of the structure of the consumer price index (CPI) underlying basket and significant increases in the prices of volatile food and oil.

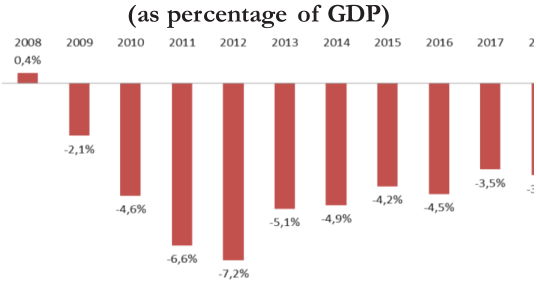
Regarding macroeconomic balances, after a notable improvement between 2012 and 2015, the current account deficit widened to 5.5 percent of GDP in 2018, as a result mainly of a slowdown in travel receipts dynamics and a decline in remittances and GCC grants, as well as an increase in energy and capital goods imports. In parallel, the pace of fiscal consolidation that began in 2013 slowed down, and the Treasury's debt continued its slow increase, before stabilizing around 65 percent of GDP.

Chart 15: Current account deficit (as percentage of GDP)



Sources: HCP & Office des Changes

Chart 16: Budget balance (as percentage of GDP)



Sources: HCP & Ministry of Economy and Finance

On the policy side, the Moroccan authorities have been active implementing various economic and financial reforms with the aim to preserve macroeconomic balances, strengthen the resilience of the economy and promote a more private-sector-driven growth and job creation.

On the policy side, the Moroccan authorities have been actively implementing various economic and financial reforms to preserve macroeconomic balances, strengthen the resilience of the economy, and promote a more private-sector-driven growth and job creation.

To preserve the soundness and sustainability of public finances, the Government lifted domestic oil price subsidies in 2013 and liberalized the domestic oil market. In 2015, it started progressively implementing a new Bylaw on Finance Acts to improve the visibility, discipline, and transparency of public finances, notably by introducing results-based management, multi-annual programming, and a golden rule for government borrowing. In 2016, several parameters of the civil servant public pension schemes have been adjusted, increasing the age of retirement and basing the pension amount on the average salary of the last eight years instead of the last salary.

To reduce redundancies and improve efficiency and coherence of the social policy, the Government launched a major project to develop an integrated social policy framework on the basis of a single social register that will allow better targeting of the population, and increase buffers for social and economic investment.

In addition, the authorities continue their efforts to improve the business climate and promote investment. These efforts include a major reform of the justice system, the reform of the regional investment centers, the reduction of payment delays, as well as the introduction of several tax measures in favor of the private sector, including the adoption of a progressive tax regime for corporates. The results in this area are encouraging, as evidenced by the country's improving position in various international rankings such as the World Bank’s Doing Business.

To further improve access to finance, several measures have been implemented including the launch of the participatory finance with the approval of five banks and three windows, the issuance of the first sovereign sukuk, the amendment of the microcredit law and the launch of a National Financial Inclusion Strategy and a national mobile payment system.

II- A new institutional environment for the conduct of monetary policy

The conduct of monetary policy in Morocco has undergone several changes in recent years to keep pace with the transformations and developments in the domestic economy and the financial sector.

1- A new central bank law

In 2014, the Bank launched a revision process of its statutes to take into consideration the developments in both the international and national environments. The new law, which entered into force in July 2019, strengthened the central bank's monetary policy autonomy, giving it particularly sole responsibility to define the objective of price stability and to conduct monetary policy.

Moreover, it clarifies the Bank's prerogatives in implementing exchange rate policy while the definition of the exchange rate regime falls under the responsibility of the Government but still after consultation with the central bank. The Bank is authorized to mobilize foreign exchange reserves for the purpose of preserving and assuring the stability of the national currency.

Additionally, the new law has extended the Bank's missions to contribute to preventing systemic risk, thus giving it the responsibility to take any measure in this area, particularly the provision of emergency liquidity and the possibility of taking stakes in credit institutions in the context of systemic risk management and banking crisis resolution temporarily.

It has also extended its missions to financial stability. In this regard, the Bank developed an assessment and analytical framework and assumed the role of the secretariat of a coordinating committee stated by the banking act, which includes among its members the other regulators of the financial sector.

Finally, the mandate of the Bank has been extended to financial inclusion. To that end, the central bank developed with the Ministry of Finance a financial inclusion strategy and is working with all stakeholders for its implementation. The ultimate goal is to generalize access to financial services and reduce inequalities for the benefit of youth, women, and the rural population. The challenge in this area is substantial, given that access to financial services is still low, as evidenced by the World Bank Findex data.

2- Transition to a more flexible exchange rate regime

Since independence, Morocco has adopted a fixed exchange rate regime that has allowed some stability of its currency against those of its main trade partners, mainly in the eurozone. The Moroccan authorities have pursued since the early 1980s a policy of openness and liberalization, which accelerated since the early 2000s.

They have signed several free trade agreements, attracted significant flows of FDI, and encouraged the Moroccan banks to expand towards the African continent. More recently, Morocco has established a financial hub in Casablanca and worked to raise it as a gate to Africa. In line with this outward-oriented policy, the authorities initiated on January 15, 2018, a gradual transition to a more flexible exchange rate regime. This reform would also allow for more autonomy for monetary policy to achieve its objective of price stability, by focusing the use of its key rate instrument mainly on price stability.

The first phase consisted of widening the fluctuation band of the dirham from ± 0.3 percent to ± 2.5 percent while maintaining unchanged the reference basket as the basis for calculating the central rate set by Bank Al-Maghrib based on a currency basket composed of 60 percent of the euro and 40 percent of the US dollar. At a later stage of the transition, the central bank will put in place an inflation targeting framework, and the nominal anchor of monetary policy will be the level of inflation instead of the exchange rate.

Many efforts have been made to support the transition, both on the operational, analytical, and communication aspects. The Bank overhauled its monetary policy analysis and forecasting system and the operational framework for intervention in the foreign exchange market. At the same time, it developed and implemented a communication strategy, focusing more specifically on preparing economic operators, especially import and export-oriented small and medium-sized enterprises, and raising awareness of the public in general about the implications of this reform. An effort of sensitization and consultation was also carried out with the banking system, called upon to play a central role in the implementation of this reform.

Adapting the operational framework

The implementation of this initial phase was coupled with several measures aimed at improving the market price-setting mechanism as well as deepening the interbank foreign exchange market. Bank Al-Maghrib introduced a new market price-setting mechanism within the limits of the fluctuation band. To this end, the Bank set up the status of market holders, giving banks exclusive access to foreign exchange auctions in return for their commitments to quotations on the interbank foreign exchange market.

These quotations are also used by the Bank to determine the dirham's reference rates against other currencies in accordance with international practices. The Bank also reviewed the framework of its intervention in the foreign exchange market to gradually reduce them.

Accordingly, it adopted currency auctions as the main instrument of intervention. All interventions are carried out within a limit of a budget determined in such a way to maintain the foreign exchange reserves at an adequate level. The objective is to allow for the interbank market to develop further and therefore lead to a better price setting according to the law of supply and demand. Meanwhile, Bank Al-Maghrib should act as a last resort lender. To boost the interbank foreign exchange market and improve its liquidity, it made available to banks market holders an electronic currency trading platform and decided to restrict its exchanges with banks to foreign currencies against foreign currencies.

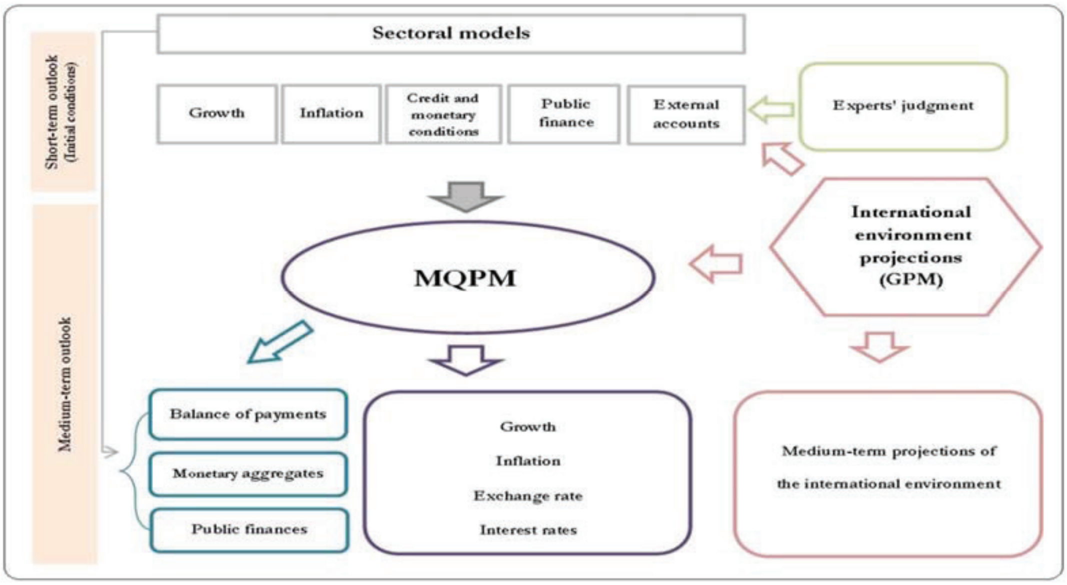
Forecasting and analytical framework

Regarding the analytical aspect of monetary policy, a new analytical and forecasting framework (FPAS) has been developed and put in place in 2016. It should support BAM's monetary policy decisions during the gradual transition toward a more flexible exchange rate regime through the eventual adoption of an inflation targeting. The FPAS is based on a quarterly projection model (MQPM), which is a semi-structural business cycle model for the Moroccan economy, ensuring both the theoretical coherence of structural models (stochastic dynamic general equilibrium models) and the empirical fitting to data provided by econometric models. It is a flexible model that produces medium-term forecasts in several stages and is interactive as it integrates the judgments of sector experts. It is composed of four interconnected blocks:

I. The monetary policy block considers the fixed exchange rate regime and the restricted capital mobility for residents, giving monetary policy some autonomy in setting interest rates;
II. The aggregate demand block formalizes growth dynamics from a demand perspective to capture inflationary pressures while distinguishing their origin and the transmission of monetary policy decisions to the real economy;
III. The aggregate supply block describes the prices dynamics by distinguishing four subcomponents: core inflation, fuel prices, regulated prices, and volatile food prices;

IV. The external block captures the evolution of the international economic situation and is exogenous.

Chart (17)
Architecture of the forecasting system



The MQPM is supplemented by several satellite models to produce the initial conditions and medium-term projections of other aggregates that are not included in the MQPM, notably agricultural output, public finance, current account, international reserves, and bank lending. To ensure the overall consistency of the projections, sectoral experts use the medium-term forecasts (growth, inflation, interest rates, and exchange rates) delivered by the MQPM as inputs in their econometric models.

This forecasting model was designed to accommodate both the current fixed exchange rate regime with capital controls and the alternative situation of a floating exchange rate regime with a gradual increase in capital mobility(18). The main difference between the two regimes lies in the long-run nominal anchor. Indeed, in a fixed exchange rate regime, the anchor is the nominal exchange rate, while in a flexible one, it is the long-term inflation rate defined by an explicit inflation target. As such, the two blocks of the exchange rate and interest rate of the central model will be impacted when migrating to a floating regime, while

18 The framework will eventually require full reassessment and recalibration to reflect long-term modifications to agents' behavior under the new regime to be ready for the adoption of a full-fledged inflation-forecast-targeting regime.

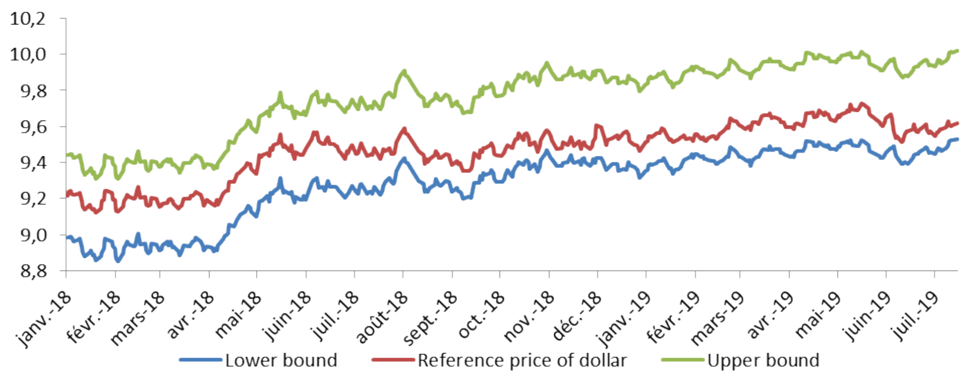
all other behavioral equations will remain unchanged. Similarly, sectoral econometric models would also be affected by this switch, while economic agents and dynamics are reshaped by the new environment.

On another side, the misalignment assessment based on the IMF approach indicates that the exchange rate has remained in recent years in line with its macroeconomic fundamentals.

Assessment of the first phase of the transition

Thanks to thorough preparation and a broad consultation process, the implementation of this reform is underway in good conditions, with a wide appropriation by the banking system, a gradual adaptation of economic operators, and a deepening of the interbank market. Also, reflecting its alignment with economic fundamentals, the exchange rate has evolved within the band without the Central Bank's interventions.

Chart (18)
The Reference price of the USD in MAD



This first phase also provided a comfortable foreign exchange position for banks that didn't have recourse to BAM since March 20th, 2018, as well as a positive perception by foreign investors, international institutions, and rating agencies.

Chart 19: Net foreign exchange position (in billions of dirhams)

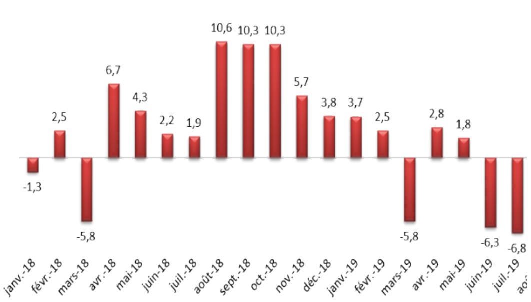
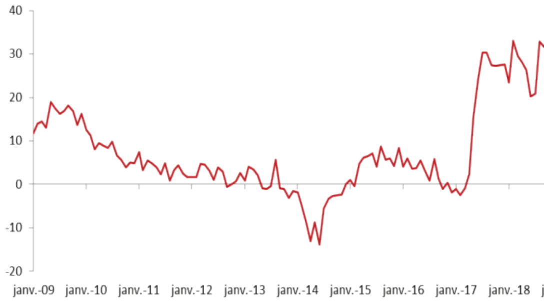


Chart 20: Banks' net foreign assets (in billions of dirhams)



3- Introduction of participatory finance

Participatory finance in Morocco was officially introduced in 2017 with the main objective of enlarging the country's banking landscape and providing alternative financing for a specific group, hence improving financial inclusion. Ultimately, this new activity should attract part of the savings hoarded outside the banking system, contributing to a better mobilization of savings and a strengthening of the liquidity situation. In addition, the multiplication of participatory banks would promote competition in the banking sector, which could lead to a reduction in financing costs.

As for the Sukuk market, it is an essential component of the participatory finance ecosystem, enabling the different players to manage their resources and liquidity better. The Sharia-compliant investment securities give investors proportional and undivided ownership rights over the underlying assets or the income they generate instead of fixed or variable interest in the case of conventional obligations.

The official introduction of participatory finance in Morocco was the result of a long process of regulatory adjustment by Bank Al-Maghrib, particularly in the context of the 2014 banking law. A Participatory Finance Committee, under the authority of the Higher Council of Ulemas, was created in February 2015 with the main task of deciding on the compliance with the Islam’s precepts of the participatory finance products offered by banks, insurers and securitization companies to their clients. To ensure the scientific rigor of this independent entity, it uses five permanent experts specialized in the legal fields and related to participatory finance, banking, insurance, and capital markets.

Since its launch, the participatory activity is progressing at a moderate pace. Its ecosystem currently consists of five banks [19] and three windows[20] whose activity did not effectively start until 2018. At the end of December 2018, which marked the first full year of operation of participatory banks and windows, there were 100 agencies spread throughout the country, compared with 44 in 2017. They recorded a total balance sheet of 7.3 billion dirhams as against 2.6 billion in 2017. The outstanding financing amounted to approximately 4.5 billion dirhams at the end of 2018, of which more than 90 percent in the form of «real estate Murabaha» and 8 percent of «automobile Murabaha».

The year 2018 was also marked by the first sovereign issue of Sukuk certificates, to which four participatory banks subscribed for a total amount of nearly 380 million dirhams, the equivalent of 5 percent of the total balance sheet.

Bank Al-Maghrib continues to support and monitor this activity. The regulatory framework has been strengthened by the preparation of prudential texts relating to equity capital and the solvency ratio. The Bank has also worked with other stakeholders to put in place the other components of the participatory finance ecosystem, particularly in terms of taxation and Sukuk.

III- Monetary policy decisions and main transmission channels

In globally moderate inflation and slow growth environment, the Bank continued its accommodative monetary policy stance, maintaining its key interest rate[21] at 2.25 percent to support growth.

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19 Umnia Bank, BTI Bank (Bank Al Tamwil wal Inmaa), Bank Al Yousr , Bank Assafa , Al Akhdar Bank

20 BMCI Najmah - Crédit du Maroc Arreda and Societe Generale - Dar Al-Amane

21 The interest rate of BAM's seven-day advances to commercial banks is the main monetary policy instrument and serves as a reference for all its operations with banks

Chart 21: Policy rate and interbank market rate (percent)

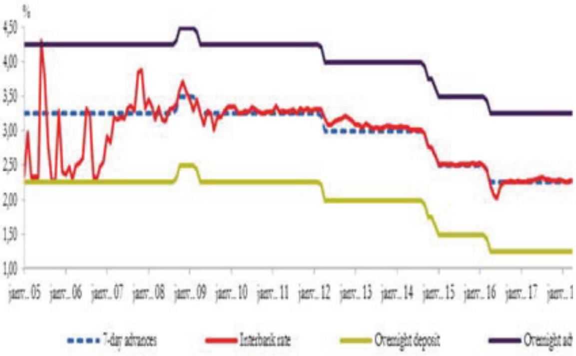
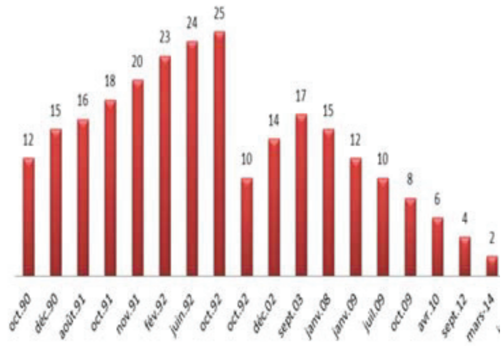


Chart 22: Required reserve ratio (percent)



Noting the persistently significant liquidity shortage in the money market due to the drop of the foreign exchange reserves and the increase in currency in circulation, BAM reduced the required reserve ratio[22] from 4 percent to 2 percent in September 2019, providing a permanent injection of over 11 billion dirhams of liquidities. The Bank also conducted in September 2019, a foreign exchange swap of 4.5 billion dirhams, the first since November 2008.

Chart 23: Structural liquidity position

(in billion dirhams)

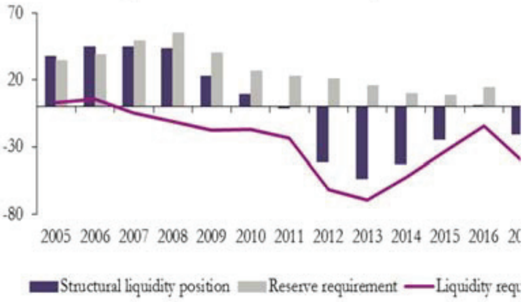
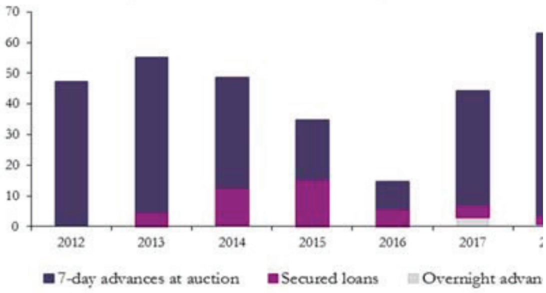


Chart 24: Bank Al-Maghrib's interventions

(in billion dirhams)



Besides, the Bank continued to implement its program to support the financing of very small, small, and medium-sized enterprises (VSMEs), set up at the end of 2013, and which aims to encourage the banking sector to increase its credit supply for this category of companies further.

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[22] The share of liabilities that commercial banks are required to keep on their demand deposits with BAM. It allows a structural regulation of banks' liquidity situation.

The transmission of monetary policy decisions in Morocco is mainly through credit and interest rate channels, while the exchange rate (Box 1) and asset price channels are relatively weak. On the interest rate side, Bank Al-Maghrib's efforts have yielded satisfactory results. Monetary conditions have eased overall in recent years, with lending rates falling to 4.98 percent in the second quarter of 2019. In particular, those applied to loans for VSMEs declined significantly, reaching 5.75 percent in the second quarter of 2019.

Regarding bank credit to the non-financial sector, which plays a vital role in financing the economy, its ratio to GDP reached 67.3 percent in 2018. In this regard, it is worth noting that the ratio of private sector credit to GDP in Morocco is of the same level as the emerging market average. With a ratio of 60.9 percent in 2018, Morocco ranks almost at the top of the lower-middle-income economies (44.5 percent of the GDP) but below middle-income countries (103.6 percent).

However, despite the advantages offered by BAM's unconventional measures and the decline in lending rates, bank loans continued to evolve at a moderate pace, affected in particular by slow growth of non-agricultural activities and a tightening of credit supply in some sectors.

Chart 25: Non-financial sector loans (YoY, percent)

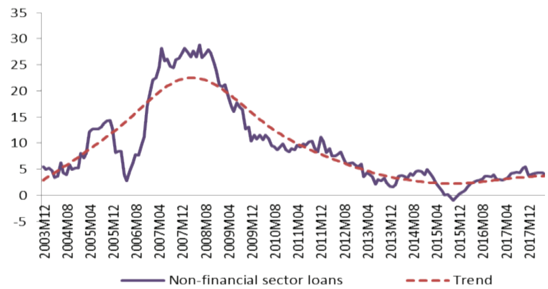
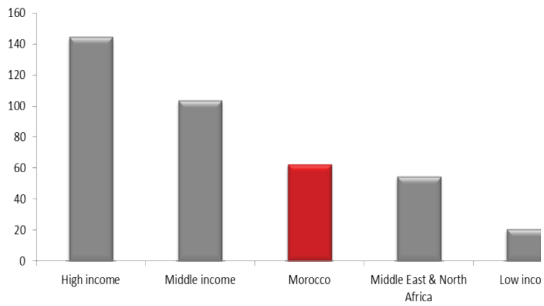


Chart 26: Private sector credit in 2018 (as percent of GDP)



Box 1: Exchange rate channel in Morocco

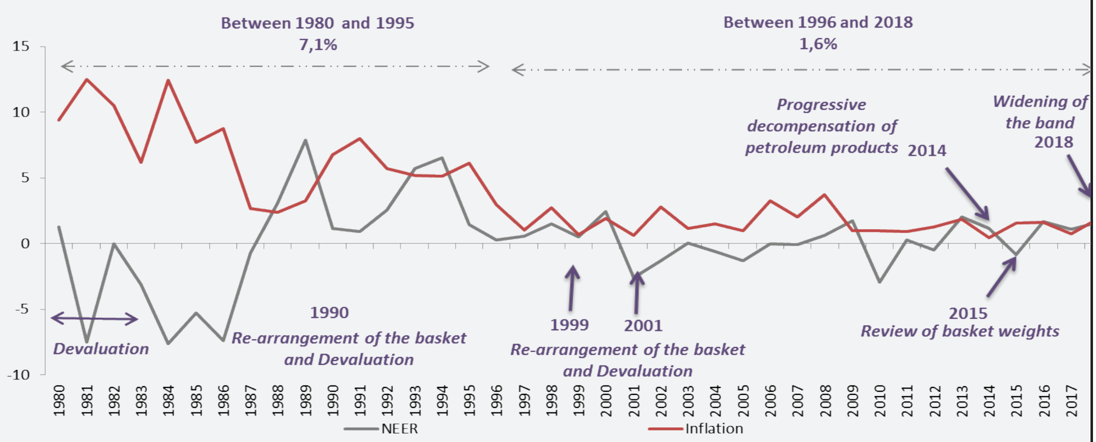
Theoretically, the exchange rate channel consists of two steps. The first is the pass-through of monetary policy decisions to the exchange rate, while the second includes the direct and indirect impacts of exchange rate fluctuations on inflation and economic activity.

In the case of Morocco, the first transmission channel is not currently active due to the pegged exchange rate regime, and to a lesser extent to restrictions on the capital account for residents. To assess the impact of changes in exchange rate on inflation, several studies have been conducted, and the results suggest an incomplete and moderate pass through, owing to several factors.

The low level of inflation since the mid-1990s in Morocco, in conjunction with a fixed exchange rate regime, induced low volatility of the real effective exchange rate, thus ensuring price stability. In addition, the subsidies system that the Moroccan authorities put in place to support household purchasing power, has contributed to the moderation of inflation, in particular before 2013, when it was significantly reduced.

At the same time, the increasing openness of the national economy (openness -as measured by the ratio of exports and imports to GDP- of nearly 68 percent in 2018 compared to 40 percent in 1990), and the multiplicity of free trade agreements (especially with African countries) have enabled some diversification of supply sources, reducing thereby exposure to external price shocks.

Chart 27: Inflation and nominal effective exchange rate



Source: IMF

The way forward

The central bank of Morocco has set as a major objective to continue the reform of the exchange rate regime and to establish an inflation-targeting framework at the latter stages of the flexibilization process. This transition will be carried out in an orderly process with a gradual widening of the band of fluctuation of the exchange rate and abandoning the reference basket at a later stage. The pace of the transition will depend not only on the assessment of its prerequisites among which macroeconomic balances and fiscal discipline but also on the ability of the economic operators, mainly export and import oriented enterprises to adapt to the higher exchange rate risk environment.

At an advanced stage, this reform will not be without impact on the conduct of monetary policy. The exchange rate as a nominal anchor would be abandoned, offering more autonomy to monetary policy to achieve its objective of price stability. Under these circumstances, the Bank could move towards an inflation-targeting framework. An explicit inflation target in the form of a point or an interval will be fixed and announced. This requires an adaptation of the monetary policy conduct at all levels, governance, instruments, implementation, and communication. The Central Bank has already started to develop such a framework and has achieved significant progress in this way.

However, to reach its ultimate objective of strengthening the resilience of the economy and support its competitiveness, this transition needs to be accompanied by other structural reforms to enhance productivity and improve the business climate. In this regard, improving the education system remains one of the main challenges facing Morocco. The reason why the authorities are implementing an important reform "Vision 2030", which, hopefully, should start yielding results in the upcoming years.

Central Bank Background Papers on Monetary Policy Frameworks in the Arab Countries

AMF - BIS Third Working Party Meeting on

Monetary Policy in the Arab Region

Russian Federation

The Bank of Russia

Prepared by

Mr. Alexander Morozov

Director of Research & Forecasting Department

Abu Dhabi, United Arab Emirates

13-14th November 2019

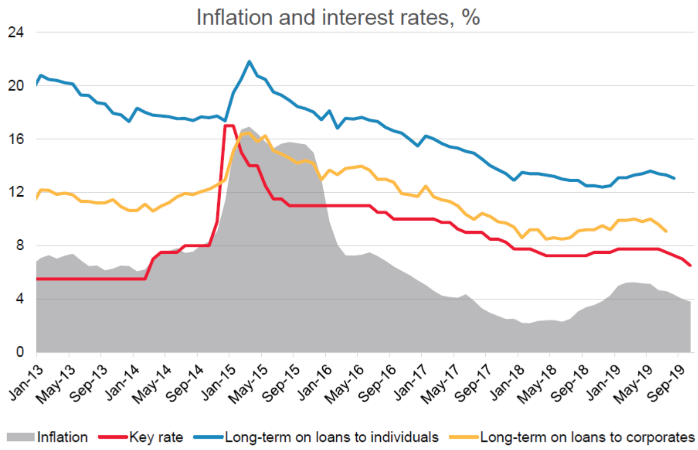
Банк России

Inflation has declined to low single-digits (historical lows)

Source: Rosstat.

Банк России

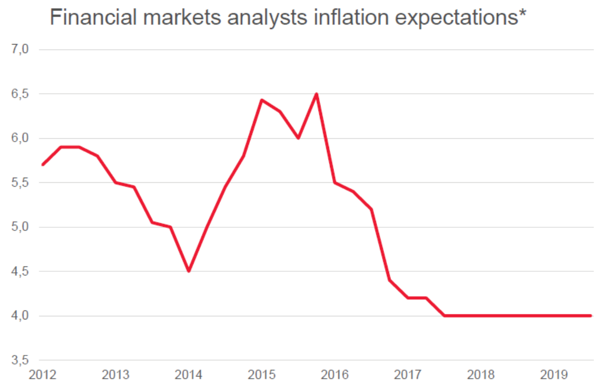
Lower inflation – lower interest rates



Sources: Bank of Russia, Rosstat.

Банк России

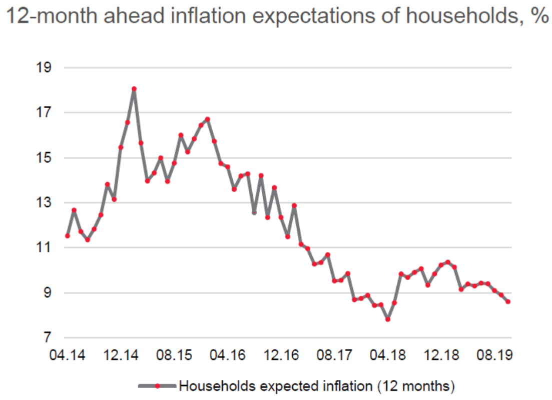
Expectations of professional forecasters are anchored



Sources: Bloomberg.
**Expectation for average inflation in T+2 year*

Банк России

Households expectations declined, yet still elevated

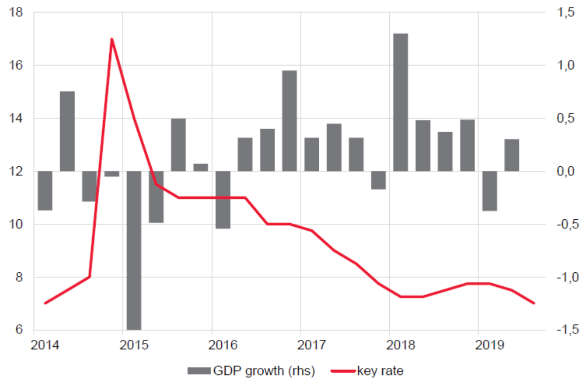


Sources: Bank of Russia

Банк России

The Russian economy returned to growth already in 2016

GDP (%, QoQ SA) and key rate

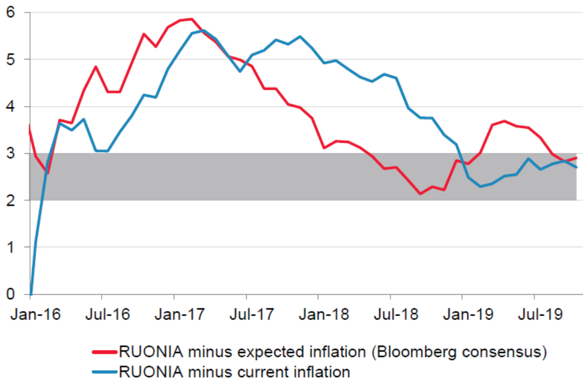


Source: Rosstat, Bloomberg Finance L.P., Bank of Russia calculations.

Банк России

Real interest rate is within the estimated neutral rate range

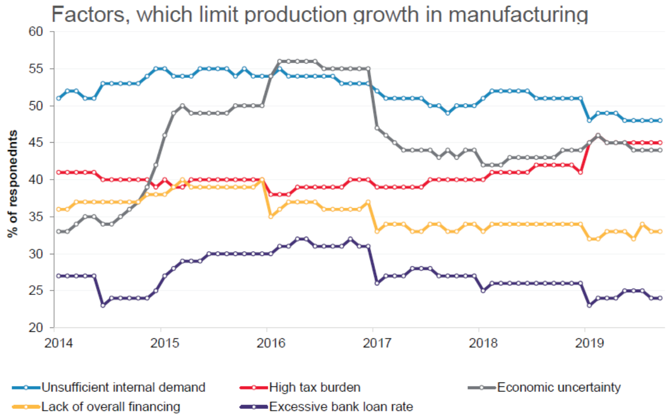
Real rate, %



Sources: Bank of Russia, Rosstat, Bloomberg.

Банк России

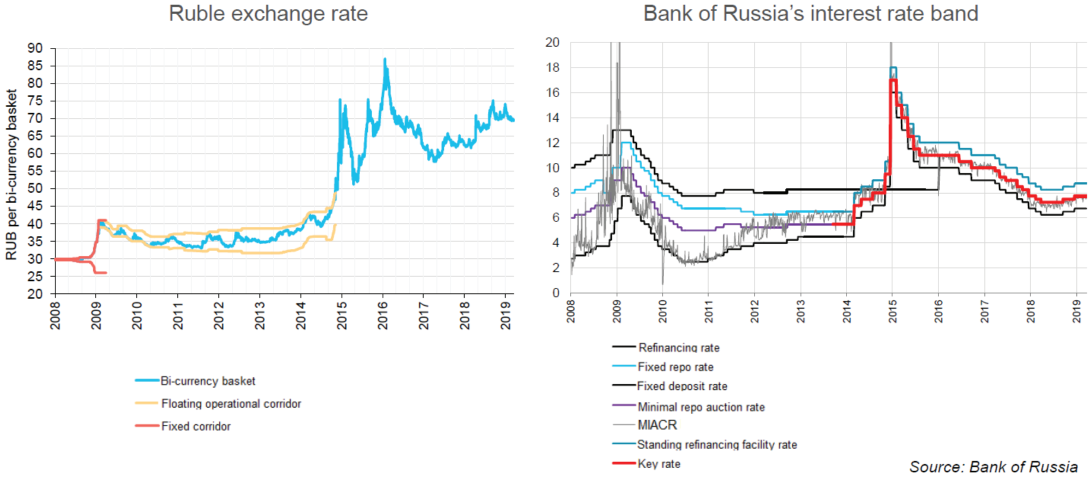
Monetary conditions have been of secondary importance for economic activity



Sources: Rosstat

Банк России

Preparation for IT: currency band widening, interest rate band narrowing



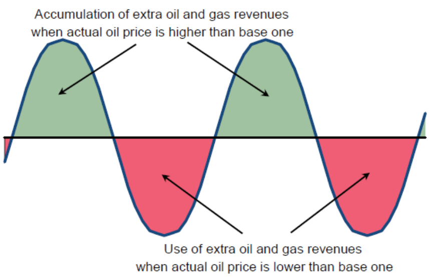
Source: Bank of Russia

Банк России

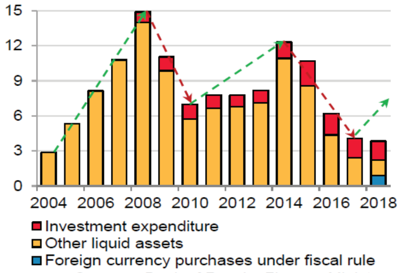
Fiscal rule in Russia

- ✓ Contributes to the achievement of both fiscal and monetary policy objectives.
- ✓ Accumulates oil and gas windfalls to decrease the dependence on oil price of key macroeconomic indicators.
- ✓ Reallocates oil and gas revenues within the oil cycles, smoothing fluctuations in fiscal spendings and reducing the risk of pro-cyclical fiscal policy.
- ✓ Stabilizes public debt, contributing to fiscal sustainability.

Reallocation of oil&gas revenues within the oil cycles



Sovereign funds, % of GDP



Sources: Bank of Russia, Finance Ministry of the Russian Federation. Rosstat.

Central Bank Background Papers on Monetary Policy Frameworks in the Arab Countries

AMF - BIS Third Working Party Meeting on

Monetary Policy in the Arab Region

The Republic of Turkey

The Central Bank of Turkey

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13-14th November 2019

Recent Financial Market Developments and Policy Responses in Turkey

Introduction

The unconventional monetary policies of advanced economies' central banks created unprecedented amounts of liquidity in the international financial system and induced surge of capital flows to emerging market economies (EMEs) in the last decade. The rapid increase in capital flows has led to the accumulation of foreign currency debt in private sectors, which has resulted in financial stability concerns. Especially after the Fed Tapering in 2013, the financial asset prices in emerging markets economies have exhibited excessive volatilities. As a result of heightened uncertainties in domestic financial markets, many central banks, including the Central Bank of the Republic of Turkey (CBRT), have adopted enhancement of stability in the financial system as one of the core responsibilities.

In this regard, many emerging market economies have implemented macroprudential policy tools to deal with sources of financial vulnerabilities. Regarding the elevated exchange rate volatility in the foreign exchange market, the CBRT has introduced a set of policy tools to contribute to the banks' foreign exchange and Turkish lira liquidity management and acts as a stabilizing actor to support financial stability consistent with its monetary and foreign exchange policy framework. While doing so, like other emerging markets, the CBRT bases its approach on effective utilization of its FX reserves and uses a diversified range of policy instruments. Consistent with this priority, in addition to the traditional FX instruments, the CBRT has enhanced its foreign exchange policy tool kit with derivative instruments since the end of 2017. Derivative instruments contribute to the efficient management of foreign exchange risk and help the CBRT achieve financial stability. This note summarizes the underlying motivation and details of these instruments.

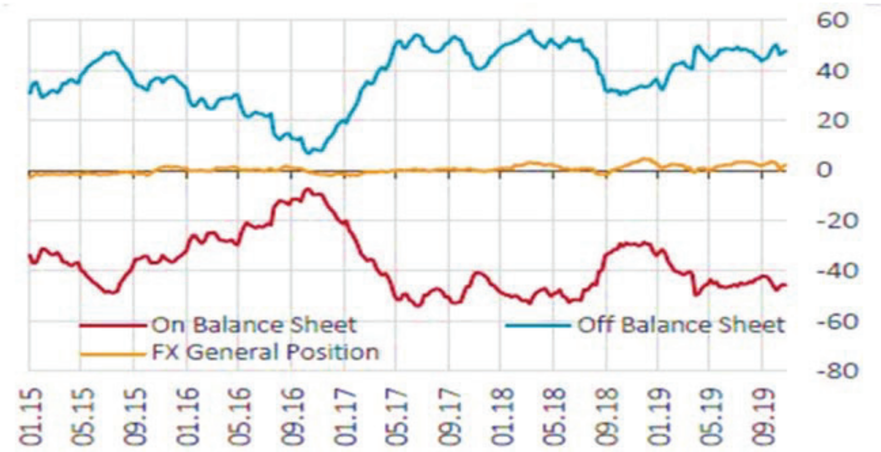
Turkish Banking Sector Foreign Exchange Balance Sheet and Implications for the Financial Stability

In order to understand the underlying motivation of the CBRT's foreign exchange derivatives policy tool kit design, the detailed examination of the Turkish banking sector balance sheet is crucial. Historically, the Turkish banking sector on-balance sheet foreign exchange liabilities tend to be larger than on-balance sheet foreign exchange assets due to dollarization of retail deposits and low cost of FX borrowing after the Global Financial Crisis. On the asset side, loans, which account for a significant portion of assets, are predominantly denominated in Turkish lira. Although the magnitude of the on-balance sheet foreign exchange position of the banking sector may change periodically due to cyclical developments, in general, banks require foreign exchange derivatives to hedge their related currency risks and manage their FX and domestic currency liquidity.

As required by the banking regulation related to the exchange rate risk management and net foreign exchange position (NFXP), the ratio of the absolute value of NFXP to a bank's capital cannot be higher than 20 percent, thus keeping banks' exchange rate risk to a minimum level. In this regard, banks tend to have long foreign exchange positions with the swap, forward, options, and other derivative transactions, of which the forward legs are recorded off-balance sheet (Figure 1). Among these derivative products, the foreign exchange swaps come to the fore as the most frequently used derivative instrument by the banks in order to manage Turkish lira and foreign exchange liquidity, hedge client transactions, and manage interest rate risk. Banks usually use short-term swaps for liquidity management while long-term swaps are mostly used for asset and liability management and hedging interest rate risks.

The numbers obtained from the BIS Triennial Central Bank Survey of Foreign Exchange and Over-the-Counter Derivatives Markets in 2019 show that the average daily FX swap turnover of transactions that involve Turkish lira is 35 billion USD, which is substantially high compared to peer countries.

Chart 1: Banking Sector FX Positions (Billion USD)



Source: BRSA.

Considering how vital it is for banks' liquidity management, the CBRT monitors the effects of any supply and demand imbalances in swap markets on financial stability and the monetary transmission mechanism closely.

In this regard, the historical data indicates that although swap market rates have been largely in line with monetary policy rates, supply and demand imbalances may cause temporary deviations of the swap rates from the policy rate. Specifically, the excess (deficient) supply of Turkish lira or deficient (excess) demand of Turkish lira at short maturities drive offshore swap rates below (above) monetary policy rates. However, it is difficult to draw a definitive conclusion as to the size of supply and demand-related factors that cause deviations observed in offshore swap rates.

In this context, the CBRT has enhanced the diversity of its monetary policy tools with the inclusion of derivative instruments to contribute to the formation of reference swap rates and to support financial stability by providing banks more liquidity management facilities. Besides the swap market, the CBRT has also taken steps in the formation of forward markets, which aim to contribute to the FX hedging of the private sector as well.

FX Derivatives Instruments Used by the CBRT as Policy Tools

1. FX Deposits Against Turkish lira Deposit Auctions

The CBRT started FX Deposit against TL Deposit Auctions on January 18, 2017, while the offshore swap rates tended to be lower than the policy rate. With these auctions, foreign exchange deposits are provided to banks against Turkish lira deposits for a given maturity. The main objectives of these auctions are to support banks in their liquidity management and help to reduce volatility in the foreign exchange market. Additionally, by using these auctions, the CBRT forms a reference rate for the OTC swap market and can tighten Turkish lira liquidity by increasing the funding need of the system when it is deemed necessary. Auctions are conducted via the traditional method in which banks only bid for FX amounts they are willing to buy from the CBRT.

Auctions are conducted via traditional method in which banks only bid for FX amounts they are willing to buy from the CBRT. Banks borrow FX from the CBRT with a maturity of one week and repay the notional amount plus the accrued interest at the maturity date. On the other leg of the transaction, banks lend TRY deposits to the CBRT with the same maturity, and receive the TRY deposit amount plus the accrued interest at maturity.

The CBRT determines TRY and USD interest rates used in the auctions in accordance with its monetary policy objectives, which provides a reference rate for offshore market rates. The international reserves of the CBRT decrease at value date, and increase at maturity due to the repayments, so there is no permanent effect on reserves. In terms of accounting, since both leg of the transactions are similar to conventional money market deposits, this instrument is recorded on-balance sheet. On the other hand, banks have been provided with the option to settle the transaction as a traditional currency swap, i.e. a combination of spot and forward FX transactions, after September 2018.

Following the heightened volatility in the last week of March 2019, short-term offshore swap rates tested historic highs as a consequence of a Turkish lira liquidity squeeze in offshore markets. Besides other policy steps, the CBRT suspended the FX Deposits against TL Deposits Auctions on March 25, 2019, to bolster the Turkish lira liquidity in the market.

2. Turkish Lira Currency Swap Market

To enhance the flexibility of the Turkish lira and FX liquidity management of banks, the CBRT also provides banks the opportunity to conduct foreign exchange swaps as a standing facility since the end of October 2018. In these transactions, the CBRT determines the spot and forward exchange rates and forms the Turkish lira interest rates implied by the forward exchange rates in line with CBRT's policy rates. The transactions are conducted via quotation method, and banks can have swap positions within their pre-determined limits. The transactions in this market do not create a permanent effect on the CBRT's reserves but increase the CBRT's reserves throughout the swap. Furthermore, by August 7th, 2019, the CBRT has begun to execute TL currency swap transactions via the traditional auction method with 1,3 to 6-month maturities to provide banks a relatively longer swap facility. Hence, banks were able to increase the average maturity of their swap positions.

3. Borsa Istanbul (BIST) Swap Market Transactions

A majority of currency swaps are conducted in over-the-counter (OTC) markets, and the global financial crisis made it necessary to monitor the trade of OTC derivatives and keep relevant risks under control. In this context, it was agreed at the 2009 G20 Pittsburgh Summit to move OTC derivatives trading to the organized markets or electronic trading platforms. Accordingly, the BIST launched a swap market in October 2018 to bring swaps, most of which were traded in the OTC market, into the organized market. This market contributes to financial stability by reducing the systemic liquidity risk in the banking sector. As stated in the Monetary and Exchange Rate Policy for 2019 document, the

CBRT, in line with its current monetary policy, also conducts Turkish lira swap transactions against US dollar and euro at various maturities at the BIST Swap Market. The CBRT swap transactions contribute to financial stability by supporting the monetary transmission mechanism and enhancing the liquidity management framework of the banking system.

4. Gold Swap Transactions against Turkish Lira and FX

To contribute to the inclusion of gold assets in the financial system, the CBRT has taken various steps. In this regard, the Turkish lira gold swap markets were opened in May 2019. Using this standing facility, banks can lend gold to the CBRT and borrow Turkish lira in exchange at the value date of the transaction. At the maturity date, while returning the gold to the banks, the CBRT receives Turkish lira from the forward gold rate determined at the initiation of the swap.

Additional to the Turkish lira/gold swap facility, in October 2019, a Foreign Exchange against Gold- Swap Market has been opened to increase the banks' efficiency in liquidity management. The transactions can be conducted both on the buy or sell sides via quotation method. By this swap facility, it is aimed to provide banks with flexibility in their gold/foreign exchange asset management, and to serve as an additional facility to bring out domestic gold savings into the financial system and hence will contribute to financial stability.

5. Turkish Lira Settled Foreign Exchange Auctions (NDF)

Forward foreign exchange contract is a type of derivative instrument actively used in financial markets to hedge against exchange rate risk. The CBRT decided to launch Turkish lira -Settled Forward Foreign Exchange Sale Auctions on November 20th, 2017, to increase depth in foreign exchange markets and support the effective management of the exchange rate risk of the corporate sector. In the framework of the program, the CBRT is in a foreign exchange-selling position in these auctions while the auction-winning banks are in a long position. Banks are also able to transfer these long FX positions to the corporate sector and/or to the markets abroad by undertaking a reverse position. Since all the transactions are made in Turkish lira, they don't have any effect on the CBRT's international reserves. This facility continued until December 31, 2018, when the CBRT decided to suspend the auctions due to diminishing demand by the banks after heightened volatility in the foreign exchange market. During this period, the CBRT held auctions in three different maturities; 1-month, 3-month, and 6-month. At the end of August 2018, the CBRT started to conduct Turkish lira-settled forward foreign exchange transactions with corporate and retail investors at the Derivatives Market (VIOP) operating under Borsa İstanbul (BIST).

This facility aims to provide an alternative tool for hedging exchange rate risk, reduce exchange rate volatility, and enhance instrument diversity within the current monetary and exchange rate policy framework. Turkish Lira Settled Foreign Exchange Transactions at BIST is not only available to domestic banks but also resident and nonresident firms, individuals and intermediary institutions. Thus, it helps the CBRT to reach a wider group of counterparties, thereby deepening domestic FX derivatives markets and contributing to the effective functioning of FX markets. Since all the transactions are settled in Turkish lira, they do not have any effect on the CBRT's international reserves.

Other Regulations and Developments that Contributes to the Financial Stability

BRSA Regulation on Banks' Derivative Positions

In August 2018, the BRSA introduced a regulation that caps the total notional principal amount of Turkish banks buying Turkish lira at maturity positions (currency swap and swap-like transactions) with foreign counterparties. According to the regulation, the total notional principal amount of banks' currency swaps and other similar products (spot + forward FX transactions) with foreign counterparties were at the initial date local banks pay Turkish lira and receive foreign exchange should not exceed 25 percent of the bank's regulatory capital.

Later, this regulation has been modified to encourage the use of longer-term FX derivative instruments. By this regulation, it is aimed to reduce speculative positions that cause unhealthy price formations and encourages the banks to conduct transactions in onshore markets. The relevant regulation contributes to financial stability as a macroprudential measure.

TLREF Turkish Lira Overnight Reference Rate

Due to the illiquid nature of interest rate swaps and underdevelopment of Turkish lira short term reference rates in the domestic markets, the banks tend to use cross-currency swaps to manage their interest rate risks. In this regard, the TLREF Turkish Lira Overnight Reference Rate is created to meet the need for Turkish Lira short-term reference rate that can be used as an underlying or a benchmark in financial products, debt instruments, and different types of financial contracts. TLREF rate that is calculated by using the overnight repo transactions at the BIST Repo- Reverse Repo Market and secured by TL denominated government debt securities.

The formation of the TLREF framework is a joint effort of representatives from Borsa İstanbul, the Central Bank of the Republic of Turkey, Republic of Turkey Ministry of Treasury and Finance, The Banks Association of Turkey, Turkish Capital Markets Association, İstanbul Settlement, and Custody Bank. Following the public announcement of daily reference rates, banks have started to issue floating-rate bonds indexed to the TLREF and have actively quoted overnight indexed swap quotations based on the TLREF.

Concluding Remarks

Recent financial market developments have proven that preserving stability in the financial markets is a necessity for the CBRT to reach its primary target of achieving long-term stable inflation. As it is stated in the Monetary and Exchange Rate Policy Text for 2019, the primary objective of the CBRT is to achieve price stability and the CBRT safeguard financial stability as a supporting element of price stability. The CBRT closely monitors exchange rate developments and risk factors related to it and takes necessary measures and uses relevant instruments to make sure that the FX market operates efficiently. In conclusion, the policy steps taken by the CBRT and other authorities have contributed to strengthening the monetary transmission mechanism and financial stability as well as decreasing volatility in FX markets.

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